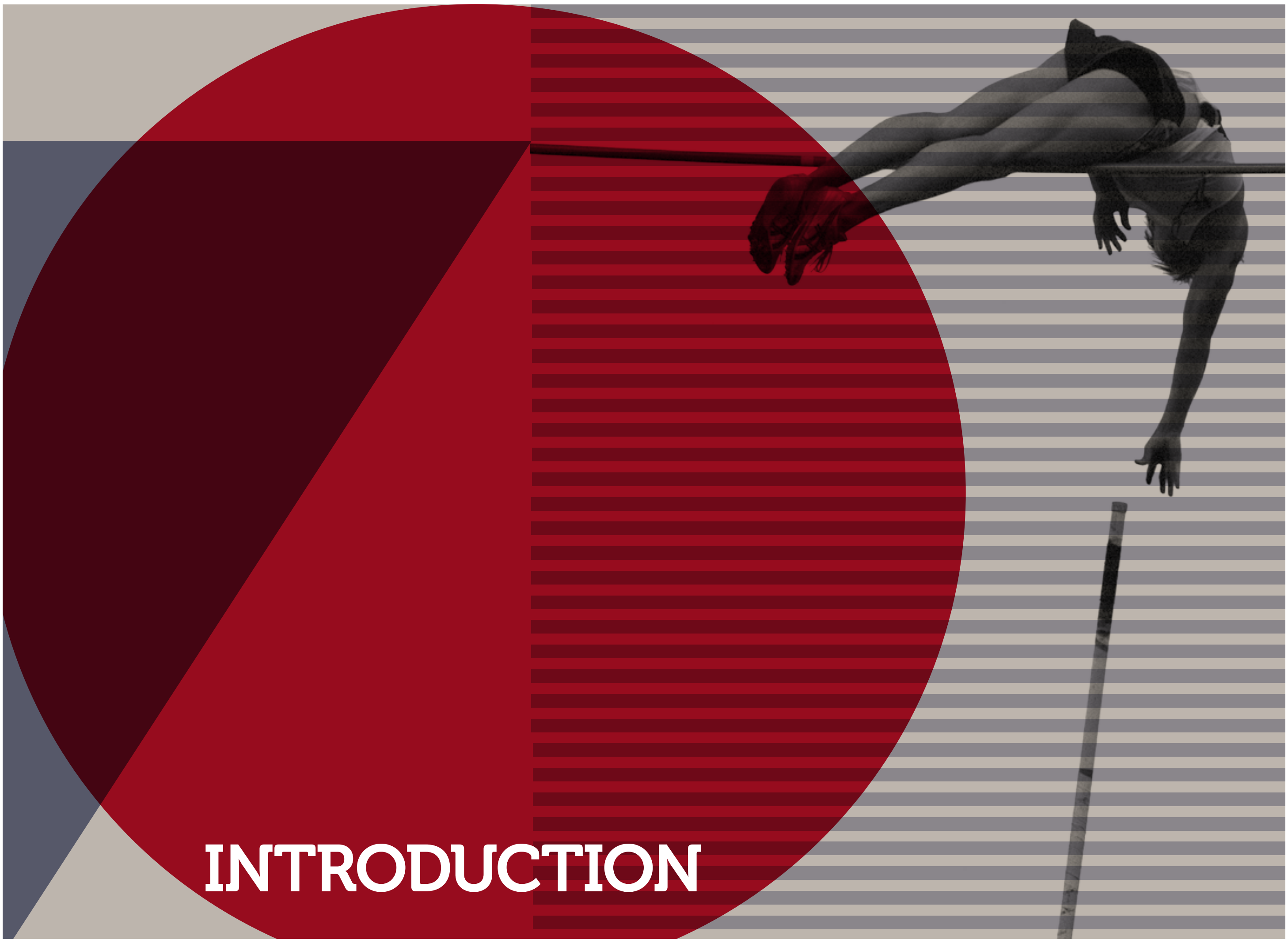
Redwheel UK Climate Engagement Strategy

PRIMER
January 2023

Contents



INTRODUCTION

This is a primer for the Redwheel UK Climate Engagement strategy. Our purpose here is to explain the financial objective and climate aim of the strategy. This includes a brief discussion on the science and the effectiveness of divestment and active ownership as alternative approaches in responding to climate warming. We touch on often-overlooked opportunities within the transition. The primer also sets out why we think this strategy addresses a gap in product offerings.

Section two will focus on the strategy itself. We intend for this primer to offer a clear explanation of the strategy, including the investment process, climate assessment framework, and the active ownership approach at its core. It also sets out the limitations of the strategy, what it can and cannot be reasonably expected to achieve, and what impact the climate aim may have on your financial returns.

The measurement of financial returns is straightforward, the attribution of returns to the skill or investment process of the manager, rather than the randomness of the market, is challenging and nuanced. Measuring the achievement of a climate aim is also challenging (alignment to the Paris Agreement is not formulaic) and the contribution of the manager to that outcome arguably less clear cut.

This is especially true within listed equities, where the existence of a large and diffused shareholder register makes the assessment of any contribution made by an individual portfolio manager to a particular outcome especially difficult to measure. This is what makes it of greater importance to explain intent and process, which we will reinforce with detailed reporting.

Our engagements with companies on climate and the realisation of shareholder value underpinning our financial returns, both require a long-term investment horizon further detailed in this document.

"It is unequivocal that human influence has warmed the atmosphere, ocean and land. Widespread and rapid changes in the atmosphere, ocean, cryosphere and biosphere have occurred." IPCC AR6

"Human-induced climate change is already affecting many weather and climate extremes in every region across the globe. Evidence of observed changes in extremes such as heatwaves, heavy precipitation, droughts, and tropical cyclones, and, in particular, their attribution to human influence, has strengthened since AR5." IPCC AR6

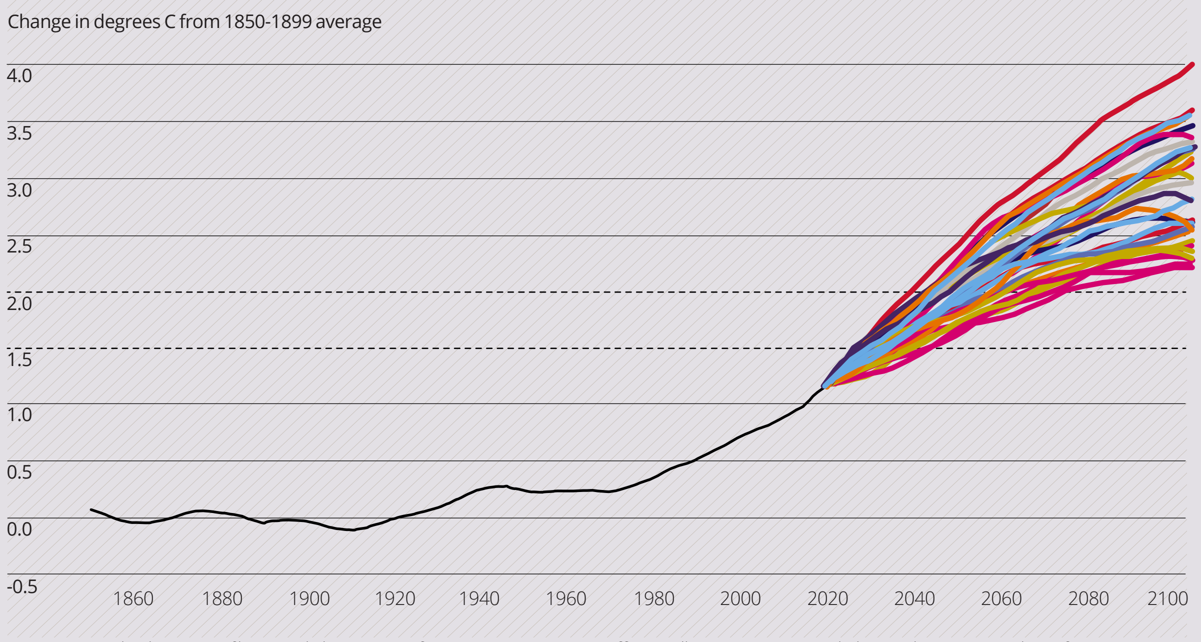
A NEW TYPE OF MANDATE

The science is clear, and the future impact of climate change is becoming arguably more certain with each Intergovernmental Panel on Climate Change (IPCC) report. We also see the evidence in the present, with extreme weather happening at an increasing frequency that can only be explained by global warming. The IPCC reports are increasingly confident about attributing these changes to human influence.

There is global acceptance that action must be taken to mitigate climate change. This is reflected in the Paris Agreement of 2015, ratified by 192 countries. The Agreement sets a clear ambition to keep temperature increases to well below 2°C from pre-industrial levels, and to aim for a more ambitious 1.5°C limit. However, the global surface temperature for 2011 to 2020 is estimated to have been 1.09°C higher than 1850 to 1900, illustrating how little time there is to meet the 1.5°C target. Carbon Brief state that "[t]he world will likely exceed 1.5C between 2026 and 2042 in scenarios where emissions are not rapidly reduced, with a central estimate of between 2030 and 2032."[1]

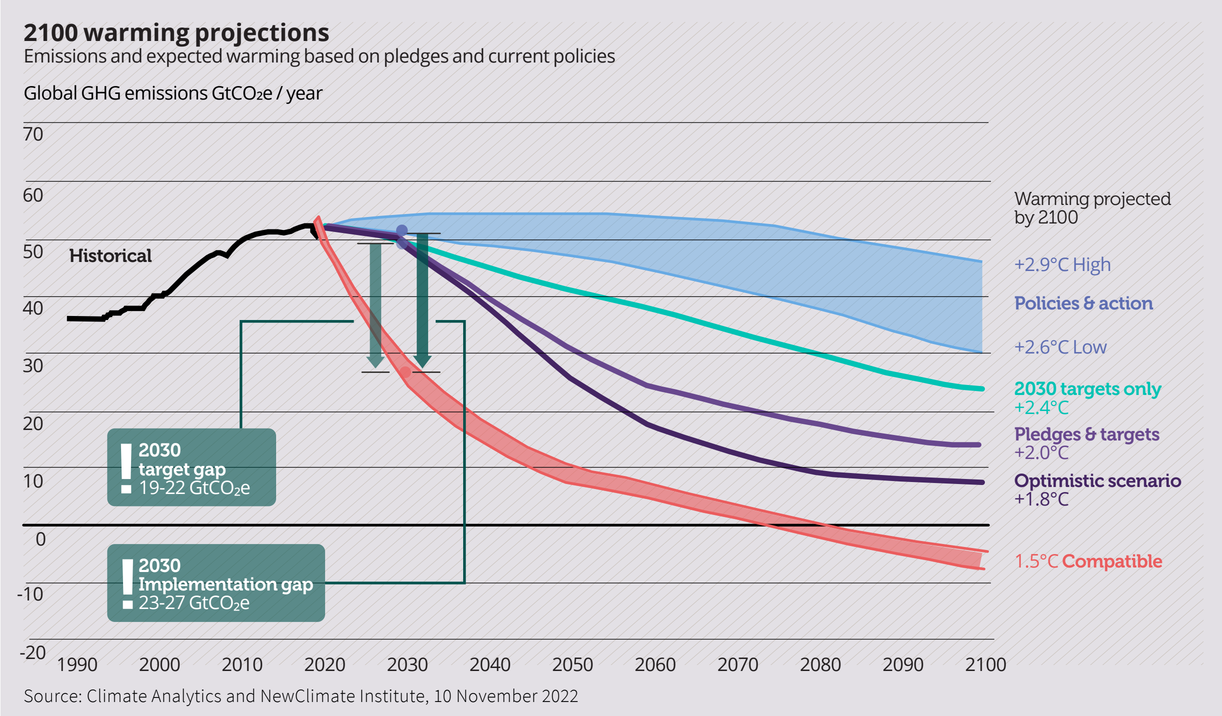
If global warming is to be limited to 1.5°C or 2°C, governments must lead in creating the policies, laws, regulations, and incentives to achieve the goals of the Paris Agreement. There has been much progress, but a large policy gap remains, with current policies and action estimated to align with a 2.7°C world. Business needs this policy gap to close to send clear market signals and to create the operating environment to encourage, require and permit widespread alignment with net zero. We cannot claim that investors or companies will provide the answers to solving the problem of climate change, in the absence of policy. To do so would grossly exaggerate the potential impact of the private sector.

Smoothed global surface temperatures from observations and models
All currently available CMIP6 SSP2-4.5 models



Source: Smoothed average of historical observations from NASA; NOAA; Met Office Hadley Centre/UEA; Berkeley Earth; Cowtan and Way from 1850-2020. Warming relative to 2020-2100 from smoothed versions of all currently available CMIP6 models running the SSP2-4.5 scenario.

[1]carbonbrief.org



However, business and investors alike cannot merely follow policy. There is no safe space for business in respect to climate change; regulation or policy may change abruptly, the timing on potential stranding of assets is unclear, consumer preferences may change faster than anticipated, disruptor solutions may transform sectors, and beneficiaries and capital owners are potentially likely to face increasing pressure to account for their financed carbon emissions, leading to pressure for further divestment. We have already seen these risks materialise to varying degrees. There are also the physical risks of climate change, which companies must manage irrespective of the policy gap.

Where then does this leave capital owners and capital allocators? Climate change raises obvious risks such as transition risk and physical risk. However, it also raises questions on values and preferences, and increasingly in external attention in how these questions are addressed. This in turn challenges fiduciary boundaries. Unfortunately, there are no simple answers in our view.

We can divest and be rid of carbon intensive exposure, but that raises its own problems. Drawing a line through large swathes of the stock market, defining them as un-investable, will reduce the investment universe, decreasing diversification and increasing concentration risk. Divestment may decarbonise a portfolio, but it may not necessarily decrease risk or improve return.

At the same time, divestment will not decarbonise the real world, a view now shared by some of the most ardent climate action campaigners.[2] Even with positive government action to close the policy gap, "we can't get to net zero by flipping a green switch"[3] as Mark Carney has said. Were greenhouse gas emissions stopped immediately, it would cause widespread and immense damage to the global economy; the impact would be felt across public and private sectors, down to the individual and their ability to work, live, travel, and meet basic needs. At the same time there would be a huge impairment to capital, hitting pension funds, endowments, and private savings. Therefore, this is a transition, an incredibly important one.

Traditional mandates are limited in their ability to meet all these challenges. While fiduciary duty requires an integration of climate considerations where they impact on an individual company or portfolio, it is solely in the context of materiality for the company or for the financial goals of the mandate. To address values or preferences and reflect climate as a systemic issue, the industry has gone down the exclusionary route. However, the weaknesses of that approach are now being exposed. On the systemic risk, divestment and exclusion have failed to deliver substantial real world decarbonisation, while such exclusion has resulted in style concentration that is now negatively affecting financial returns. Therefore, we believe there is a need to incorporate an explicit climate aim within the strategy and highlight the potential impact on financial returns. The transition is nuanced and challenging and we believe it offers both opportunities as well as trade-offs for shareholders. We can take advantage of a behavioural bias towards exclusions reflected in valuations, but we may also have to sacrifice returns to reflect our climate aim, sometimes based on values, preferences or systemic factors, rather than purely financial considerations.

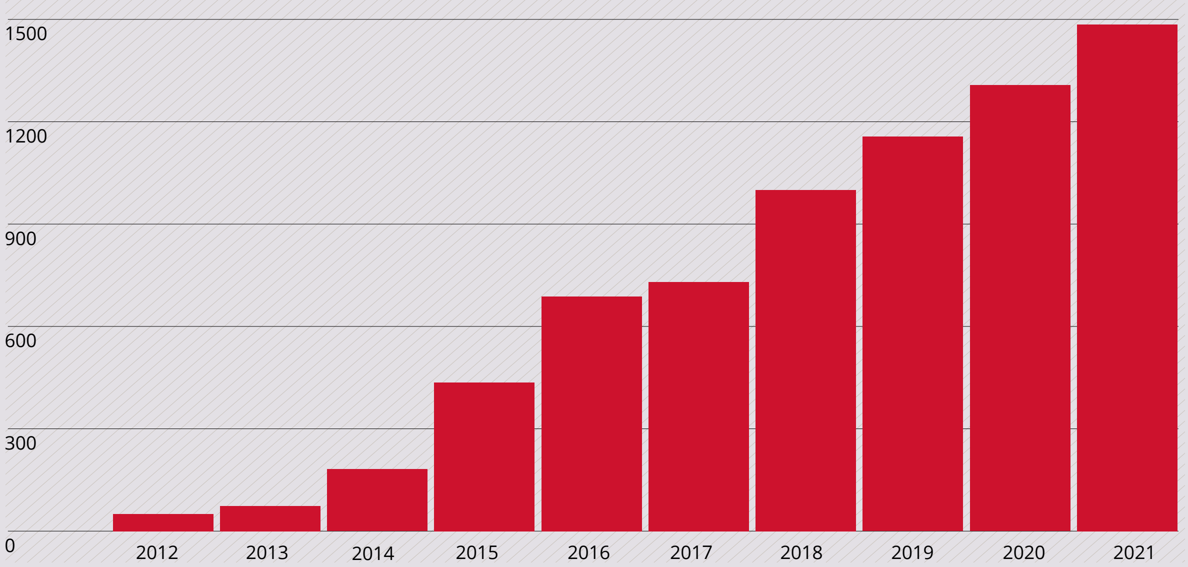
Traditional mandates are evolving in their consideration of climate change. However, they are bound by the traditional objectives focused on financial returns only. To address these limitations and to address both institutional and retail climate commitments and preferences towards mitigating global warming, climate itself needs to be clearly incorporated within the strategy, elevating climate above the basic ESG integration of traditional mandates. This is what is offered by the Redwheel UK Climate Engagement Strategy.

[2] https://lapfforum.org
[3] https://www.ft.com

THE EVIDENCE ON DIVESTMENT

The divestment movement has gained traction since the Paris Agreement in 2015 and took another leg up in 2022. It is perfectly understandable that many investors want to align their investments with their values and do not wish to profit from fossil fuel assets. It is the easiest option for investors seeking to move away from fossil fuels and carbon intensive industries and can be achieved through actual divestment of securities or exclusion of securities. Within listed equities it offers a quick solution to decarbonising or greening a portfolio. The secondary market offers a quick way to rid a portfolio of shares of carbon intensive companies, something less available to investors in private markets. However, the question is whether divestment works in decarbonising the real world.

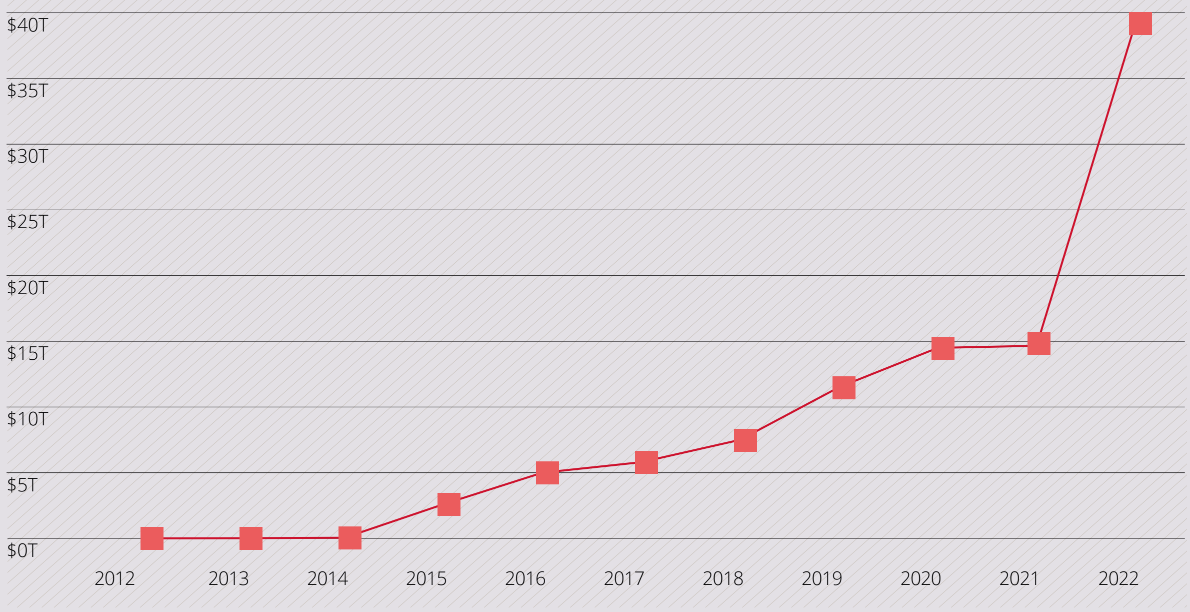
Total public institutional commitments to fossil fuel divestment



Source: Global Divestment Commitments Database

Source: Climate Analytics and NewClimate Institute, 10 November 2022

Total assets under management committed to fossil fuel divestment



*2021 figures represent an update of some institutions' total assets under management. See Methodology section.
Source: Global Divestment Commitments Database

The evidence is now clear that decarbonisation does not follow divestment. At a company level, divestment of fossil assets often results in the opposite, an increase rather than a decrease in emissions. We have written about company level divestment and its consequences many times, including "Coal Divestment", "Dear Student", and "Has Anglo American come in from the Nordic cold"? Large miners divesting their thermal coal assets has not led to a reduction in thermal coal production, rather private buyers (or state buyers such as China) have snapped up these assets. In Thungela's case, the thermal coal company spun out of Anglo American, rather than running the assets down as they were under Anglo American ownership, it is now investing to maintain production levels.

At a portfolio level the argument is the same and now many of the strongest climate action proponents are coming around to this view. Founder and chairman of CIFF, one of the world's largest philanthropic funders of climate action, Chris Hohn argues that "Decarbonising your portfolio does not decarbonise the real world"[4]. Mark Carney, former Governor of the BOE says "As much as we might wish, we can't get to net zero just by buying all the green assets"[5]. Edmans, Levit and Schneemeier in a 2022 paper entitled Socially Responsible Divestment[6] argued strongly against blanket divestment or exclusion and offered the following summary:

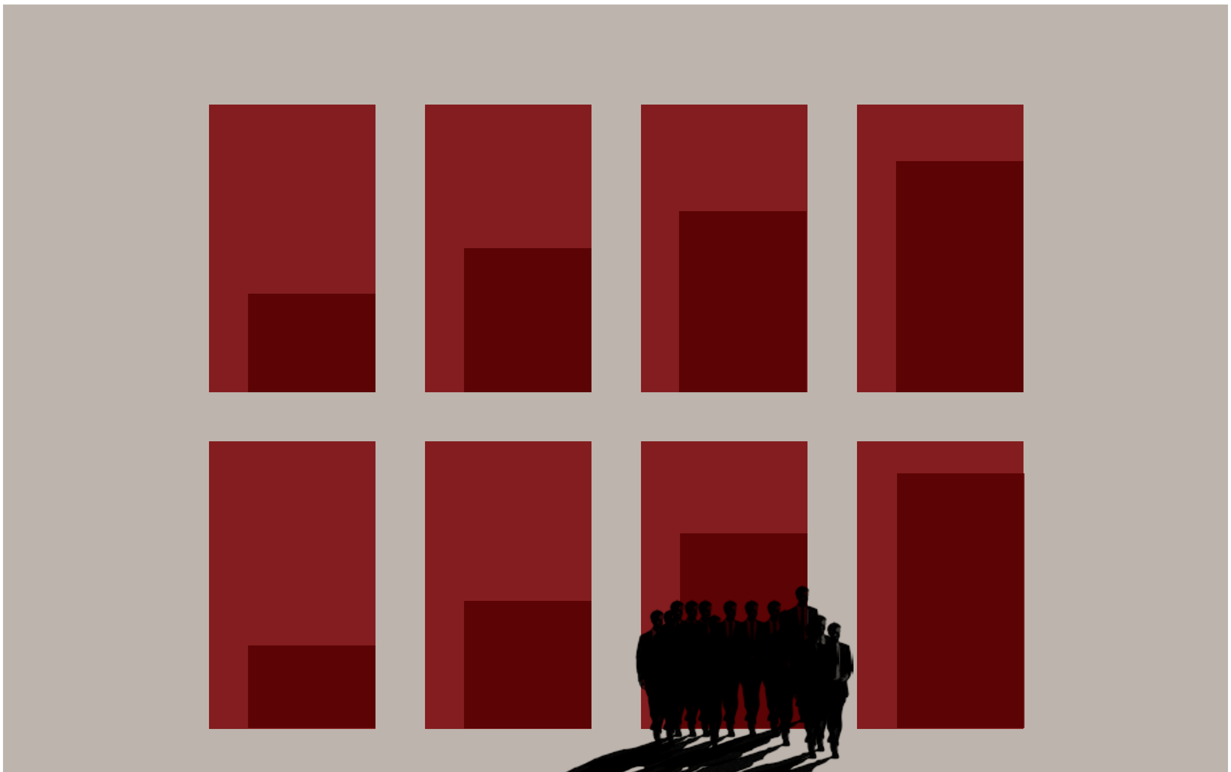
- Exclusion does not deprive a company of capital; an investor can only sell if someone else buys
- Exclusion doesn't defund a company immediately; only makes it harder to sell shares in the future
- Brown companies aren't raising much capital to begin with, as they're in yesterday's industries with few growth opportunities
- Empirically, exclusions seem somewhat ineffective

Berk and van Binsbergen argue in the Impact of Impact Investing that "the effect [of divestment] on the cost of capital is too small to be consequential".[7] Studies that claim that divestment does reduce emissions have been strongly criticised on methodological grounds.[8] Without labouring the point, divestment does not always result in firms reducing carbon emissions or necessarily changing their business model. However, Edmans et al believe tilting (overweighting climate leaders, underweighting climate laggards) or best-in-class (selects climate leaders), on a sector neutral basis, are both improvements on blanket divestment. This is because it is more likely to induce corrective action from the company; management cares about their reputation and their incentive schemes (linked to the company share price) and thus see that improvement can enhance their reputation and their compensation. This approach offers a carrot and stick, whereas blanket divestment offers no such carrot. However, adopting a tilting or best-in-class strategy reduces the flexibility to combine the potential improvement with the opportunity offered by valuation, the two former strategies possibly pay a structural valuation premium for industry leaders.

However, divestment is not a totally binary issue. In certain circumstances, divestment may be the right decision to reduce transition or physical risks for a portfolio. Some companies may not be able to transition to a low carbon business, or to do so would entail a level of risk that an investor may be unwilling to take. A pure play like Thungela should be put in run down, and a responsible investor may find it justifiable to hold the company during this period. However, as seen in this instance, management has opted for extending the life of both their assets and the company, driven by management's own interests and the wish to push environmental rehabilitation costs further into the future. The risk then is the responsible investor is left holding a rather illiquid position in a thermal coal company that will produce coal well beyond the time consistent with a 1.5-degree scenario.

We believe it is more powerful to engage with companies, or if necessary to divest a company of its management, than to divest a company's shares from our portfolios.

[4] lapfforum.org
[5] afr.com
[6] ecgi.global
[7] papers.ssrn.com
[8] tom-gosling.com



ACTIVE OWNERSHIP

As a substitute for divestment, we believe there is a strong persuasive case for active ownership, and for engagement as a central part of that approach. Combined with a climate aim, shareholders can make real progress in decarbonising the most carbon intensive companies. Furthermore, as the University of Zurich's Center for Sustainable Finance and Private Wealth (CSP) bluntly puts it, "[i]f your goal is to encourage improvement, you want to focus on those companies that have the greatest potential for improvement".[9]

Active ownership is a simple concept; shareholders are owners of companies and therefore should actively communicate with companies to influence and support long-term success and value creation, not just act as passive bystanders. It means that even where shares are not held directly by the providers of capital, portfolio managers appointed as their agents should fulfil this role on their behalf, pursuing engagement directly or in collaboration and fully exercising voting rights. The diffuse nature of ownership within public equities has hindered engagement and the fear of transgressing 'acting in concert' rules has also inhibited collaboration. However, ownership has become more concentrated. Lukomnik and Hawley quote a figure of 80% concentration of public equities within institutional owners and managers from 8% in the 1950s, in theory increasing the opportunity for effective engagements and collaborations, notwithstanding the broader question marks about such concentration.[10] Meanwhile, bodies such as the Financial Reporting Council (FRC) have clarified provisions of The Takeover Code that may "act as a barrier to co-operative action by fund managers and institutional shareholders".[11]

The FRC has also directly encouraged engagement through investor and corporate codes. The UK Corporate Governance Code 2018[12] encourages company boards to ensure they have effective engagements with shareholders, while the UK Stewardship Code 2020[13] makes engagement a central part of stewardship and mentions climate as a particular issue to consider. Therefore, broader governance developments are creating the platform for engagement and collaboration to be more accessible and more effective, it is no longer acceptable for investors to say they do not need to speak to management, that they are 'renting a stock' rather than owning it, while it is no longer acceptable for board directors to shy away from meeting shareholders, or portfolio managers as the agents of asset owners.

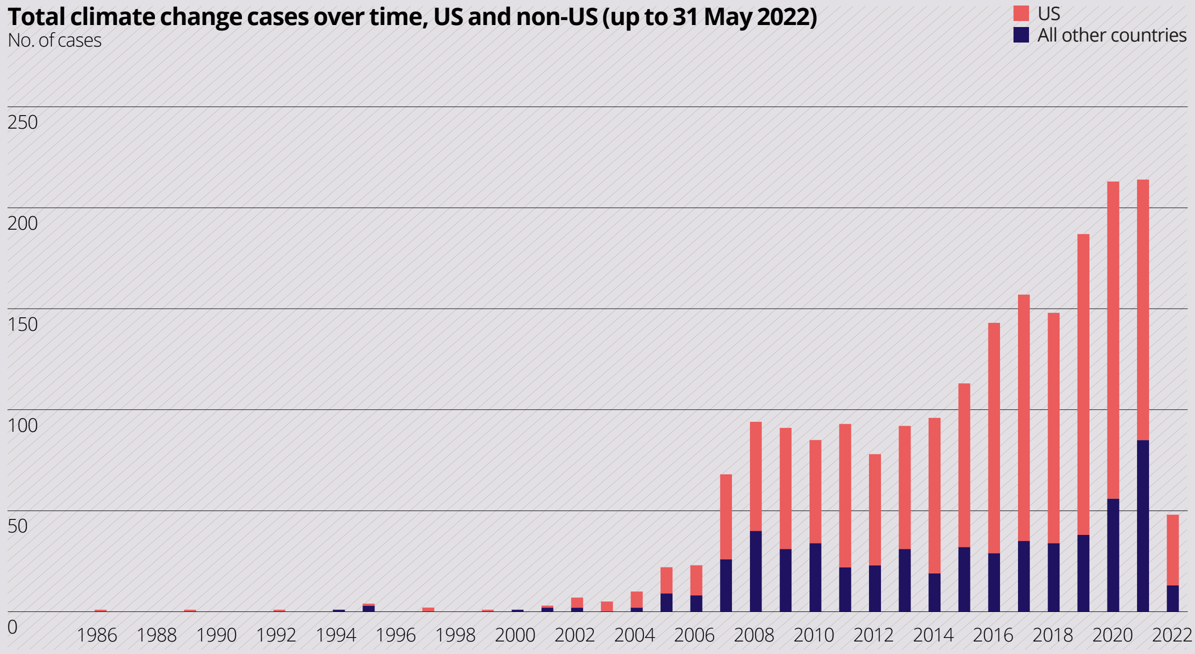
There is evidence to point to the success of engagement. Science based targets are often a key ask of investors to companies and the Science Based Target initiative (SBTi) has said that "companies with science-based targets have reduced their combined emissions by 25% since 2015, contrasting with an increase of 3.4% in global emissions from energy and industrial processes over the same period".[14]

Climate Action 100+ (CA100+), an investor initiative launched in 2017, has grown from 225 to 700 investor signatories together responsible for $68 trillion in assets and demonstrates the success of collaboration. Focusing on the most carbon intense companies, the initiative set three main goals, 1) Implement a strong governance framework on climate change, 2) Take action to reduce GHG across the value chain, consistent with the goals of the Paris Agreement, and 3) Provide enhanced corporate disclosure. When measured against these goals in October 2022 (of the 166 focus companies) 92% had some level of board oversight of climate change, 75% had committed to achieve net zero emissions by 2050, and 91% had aligned with TCFD recommendations.[15] CA100+ was initially established for a period of five years, recognising the need for urgent action. In 2022, the initiative began to consult about the next phase of their work, understanding that the initial focus has broadly been achieved, but that much work remains to be done to hit the target of halving emission by 2030.

9 Heeb, Florian, Kölbel, Julian,
10 Lukomnil, Jon, Hawley, Hames P
11 Financial Reporting Council
12 https://www.frc.org.uk
13 https://www.frc.org.uk
14 sciencebasedtargets.orgt
15 climateaction100.org

Other examples of high-profile active ownership successes include Engine No. 1 getting three directors elected to the board of ExxonMobil, while the Investor Mining and Tailings Safety Initiative led by the Church of England Pensions Board has improved disclosure and ultimately safety of tailing dams. However, most engagement or collaborative successes go unnoticed. They are more dry, technical improvements or nudges to behaviour that do not make the headlines but do elicit change in companies.

Total climate change cases over time, US and non-US (up to 31 May 2022)



Source: Global trends in climate change litigation 2022 snapshot – Policy Report Grantham Institute and LSE. June 2022

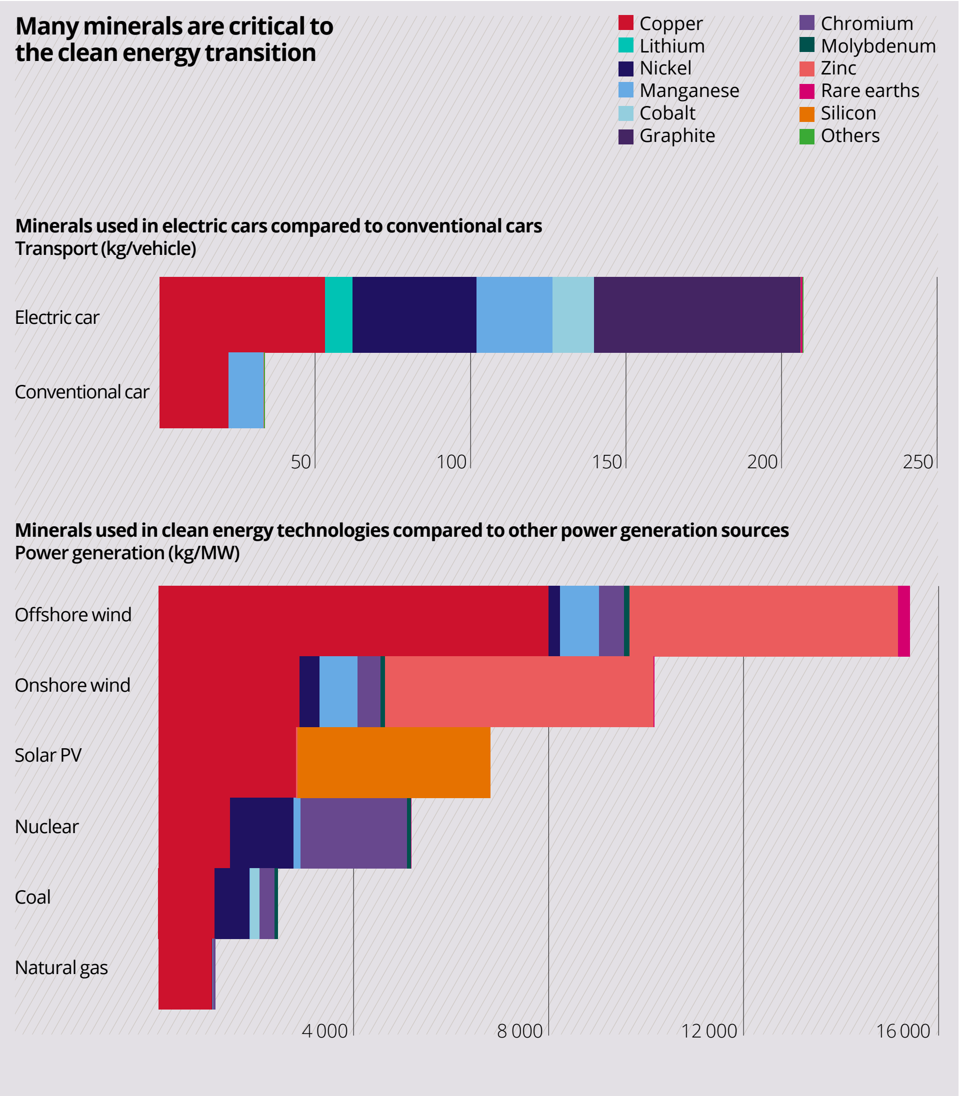
We believe engagement works because most management teams and board directors do care about the issue of climate change. Few people wish to have their legacy as one of destroying the planet, they generally care about their reputation, their integrity and wish to avoid bad publicity. However, they also care about their incentive schemes, they care about their individual positions, and they care about their legal liability. As a board they also care about their social licence to operate. Legal action against companies is increasing, a record number in 2021 with the legal action against Shell in a Dutch court being one of the highest profile cases.[16] Legal action is also focused on governments, the UK government losing a court case in July 2022 when the High Court ruled in favour Climate Earth on the inadequacy of the net zero strategy to meet the Climate Change Act commitments. The government has decided not to appeal the verdict, and this may spur new policy to address the strategy's weaknesses, with potential implications for individual companies.[17]

Our experience of engagement has been a positive one. We have found companies are willing to engage at many levels, from the technical experts to senior management and board directors. We have also found that while shareholding size does bring influence, companies are very open to engaging with smaller, well informed, long-term shareholders. But where companies are slower to engage, there are alternative means of getting their attention. That can be through participation in market-based initiatives such as CA100+, or through more formalised stewardship bodies such as The Investor Forum. It may be participating in ad-hoc collaborations, or it may be taking a more high-profile stance to ensure directors hear a message.

[16] lse.ac.uk
[17] clientearth.org/

TRANSITION OPPORTUNITIES

Many investors most often think of carbon intensive companies in a purely negative light, a downside perspective only. Combined with divestment, this has led to pressure on high emitters' valuations. Goldman Sachs research has shown that low carbon dioxide emitting companies are valued at a premium to high emitting companies and this premium has grown over the past decade.[18] However, there are many opportunities that will arise from the transition, not only for pure climate solution providers, but also for carbon intensive sectors. With a tendency to focus on the starting carbon intensity of a business and a simple approach to decarbonising portfolios, this fact is often overlooked. Not only may there be a structural undervaluation of carbon intensive companies on offer, but these companies are also in prime position to take advantage of the opportunities thrown up by the transition itself.



Source: International Energy Agency (IEA) Report: The role of critical minerals in clean energy transitions May 2021

[18] GS Sustain, The Net Zero Guide, October 2021:

One obvious opportunity arises from the demand for transition metals, such as copper, which are required to support the move to electric vehicles and the development of wind and solar energy. We wrote about this opportunity in our blog, The irony of transition metals.[19] Then there are opportunities and clear incentives to improve profit margins through resource efficiency measures (more efficient production and distribution processes, use of recycling, reduced water use, improved energy efficiency or shift to decentralised energy generation). The transition may mean an opportunity to create competitive advantage as consumer preferences and regulations change and new markets open. Government intervention may mean both policy and subsidy support, allowing private companies access to new partnerships and funding.

The development of technology to replace or change operational processes may also offer new opportunities. Anglo American has developed a prototype of the world's largest hydrogen-powered mine haul truck. The plan is to replace the entire fleet of diesel-powered trucks as part of becoming carbon neutral within their operations by 2040. Not only might the company have an opportunity to sell this technology in the future, but hydrogen fuel cell technology increases the demand for platinum, and Anglo American Platinum (79% owned by Anglo American) is the world's largest producer of the precious metal.

Goldman Sachs research has also shown that it is the transition progress, i.e., in reducing emissions intensity and momentum, and increases in green revenue/capital expenditure mix, that rewards companies with a valuation uplift, rather than disclosures which have a much smaller impact on valuation.[20] Unsurprisingly then, as the sector with the largest share of emissions and most notable transition progress, electricity generation has experienced some of the biggest and best investment opportunities over the past decade. A great example is the transformation of Danish Oil & Natural Gas Company (Dong) to Ørsted. Dong was an oil and gas producer and coal powered electricity generator. The company went on a transition from fossil fuel-based company to wind power generator, which we wrote about in our blog "Those shiny Ørsted shares? I'd rather have Dong's".[21] This transition has rewarded shareholders handsomely, with 3.7 times the return of the Stoxx Europe 600 index since the IPO in 2016 (to end September 2022). Ørsted is not the only example of fossil fuel companies leaning into the renewables business. Following similar IPOs by Iberdrola and EDF, Energias de Portugal (EDP Group) spun out EDP Renováveis (EDPR) in 2008, retaining 75% of the shares. After a rocky start (the global financial crisis, European debt crisis, regulatory uncertainty, and a drop in power prices), EDPR shares have outperformed the Stoxx Europe 600 index over the last 10 years by 5 times and outperforming by 88% over the period since the IPO. It now accounts for 85% of the EDP Group's market cap.

Photograph by Curioso Photography

"Not only may there be a structural undervaluation of carbon intensive companies on offer, but these companies are also in prime position to take advantage of the opportunities thrown up by the transition itself."

Enel did a similar spinout with Enel Green Power in 2010, before buying back the stake in 2016 and like Ørsted it shut down 40 of its 50 coal power plants between 2015 and 2021 and plans to be totally out of coal by 2025. In the process it has reduced its carbon emissions (scope 1 and scope 2) by 57%.[22] In 2022 another Italian company, the integrated oil and gas company ENI, announced a similar plan to spin 30% of its low carbon business, Plenitude.[23]

The common theme here is that the opportunity arose from within a carbon intensive company, rather than outside. The companies not only improved disclosure, but radically changed the shape of their businesses. Shareholders benefited as renewables transformed the prospects of the legacy company. However, it doesn't always work out so well, BP sold their US wind assets in 2013, as part of a programme to sell non-core assets to reduce leverage, just at the point where EDPR's share price took off. The lesson for us is that companies must have the financial strength and liquidity, to deal with the risks and to take advantage of the opportunities as the transition progresses. This is the clear message we give to our investee companies. There is no doubt that both risk and opportunity will be very much a feature of this transition to a low carbon economy.

[19] redwheel.com
[20] GS Sustain, The Net Zero Guide Rewards for climate transition plan transparency
[21] redwheel.com
[22] corporateknights.com
[23] eni.com/en-IT/media

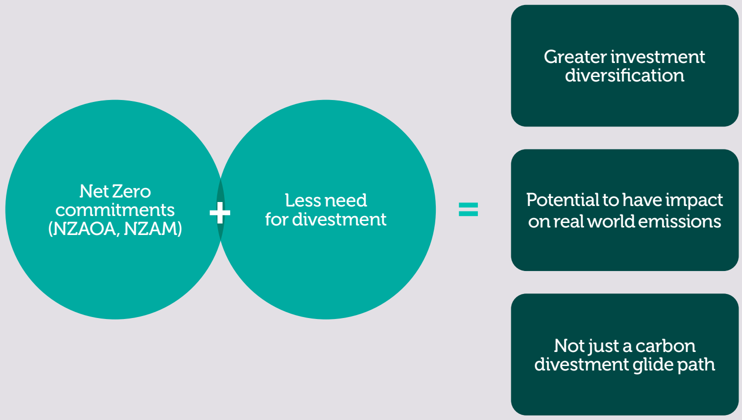
A SOLUTION FOR CAPITAL OWNERS

Capital owners and allocators are receiving an increasing amount of attention for their climate change stance, from an array of stakeholders. While evidence shows divestment does not work, it is the preferred strategy for many stakeholders and for most climate activists. Divestment is happening through hard and often publicly announced divestment, selling carbon intensive companies from portfolios. It is also happening in a less public manner through soft divestment in the form of exclusions.

There is also a risk that divestment becomes an unintended consequence through the adoption of net zero commitments by asset owners and allocators. Under the Glasgow Financial Alliance for Net Zero (GFANZ) umbrella, the Net Zero Asset Owners Alliance (NZAOA) and Net Zero Asset Managers (NZAM) Initiative signatories are committing to decarbonising their portfolios and aligning with Net Zero. One approach to meeting these commitments is simply to adopt a glide path of divestment from carbon intensive sectors, thus meeting milestone targets on portfolio decarbonisation. Such glide paths may hinder the use of sectoral pathways, seen as key to the transition of the global economy, or more nuanced alignment assessment frameworks.

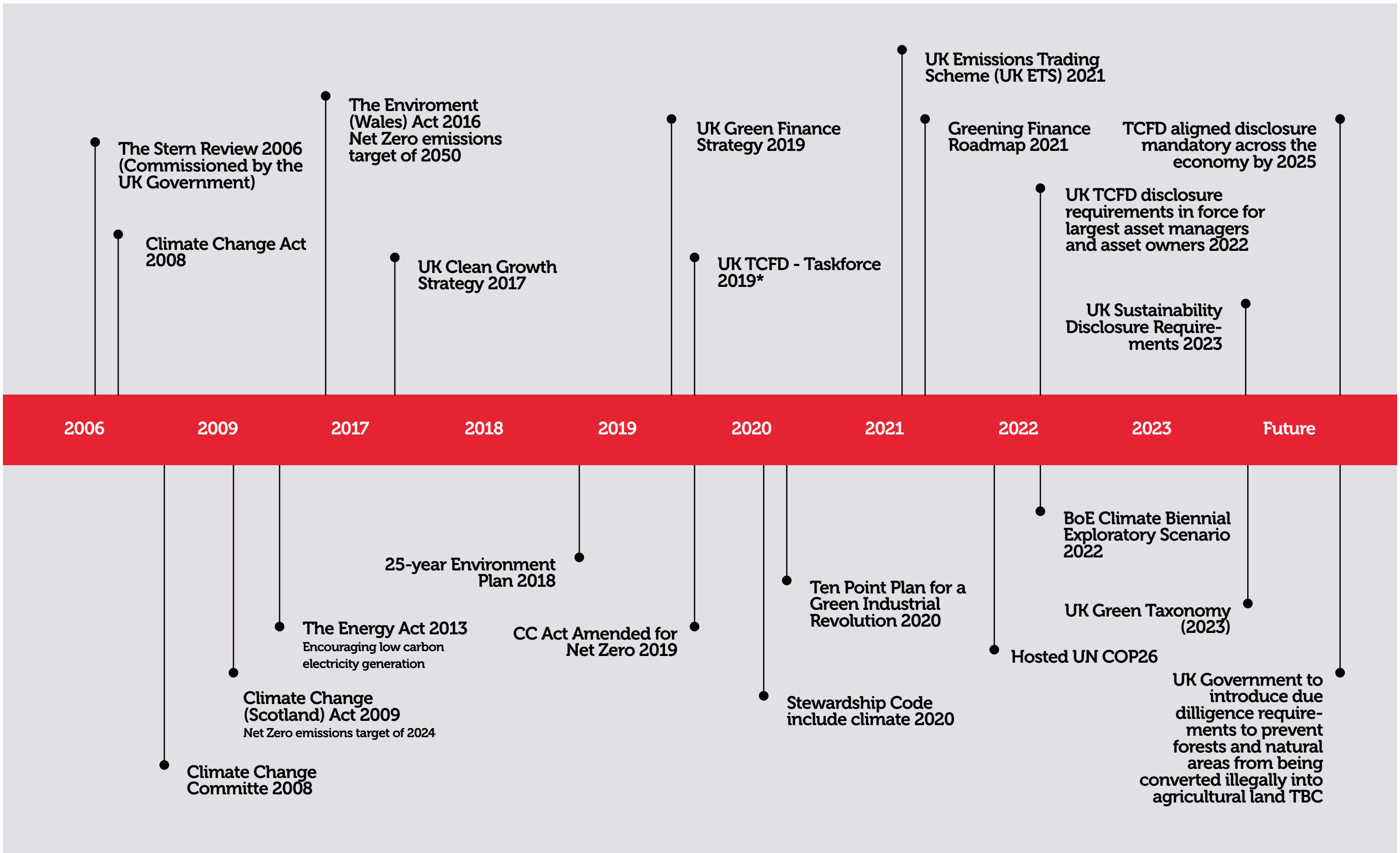
As we discussed earlier, divestment also leads to a reduced investable universe for capital allocators, therefore lower levels of diversification. It may mean limited exposure to whole sectors that play a significant role in the global economy including transport (shipping, aviation, automotive), industrials (chemicals, steel, cement), energy and power generation (oil & gas, utilities) and materials (iron, copper, nickel). Divestment may spread to financial companies who finance and facilitate these sectors. Such reduced diversification and consequent concentration on fewer sectors and constrained investment styles, will likely have a negative impact on the risk adjusted returns of listed equity portfolios.

Not just a carbon divestment glide path



An alternative approach is to remain invested, engage with companies and be a force for pushing those carbon intensive companies to decarbonise their operations and their value chains. If the engagement is successful, the reduction in real world emissions negates or reduces the need for portfolio decarbonisation via divestment. Engagement strategies are thus the natural companion to net zero commitments.

Meanwhile, the UK is one of the leading countries in introducing climate related laws and regulations, including the amendment of the Climate Change Act in 2019 to reflect the country's net zero commitment. Capital owners, particularly UK based pension funds, are seeing increasing demand in terms of their own commitments and disclosure obligations due to this trend.



THE STRATEGY OBJECTIVES

The Redwheel UK Climate Engagement strategy is a UK equity strategy with an objective to provide an income and capital return and has an explicit climate aim.

A key component of this strategy is using an in-depth climate assessment framework combined with intensive engagement applied to carbon intensive companies and companies financing or facilitating the fossil fuel industry in the portfolio. The portfolio will typically hold five to ten such companies. However, all companies within the portfolio will be subject to a climate assessment and any engagements with any holding will have alignment with the emissions pathways associated with the Paris Agreement front and centre.

Many companies express a commitment to align with the Paris Agreement, however, we cannot simply take companies at their word, or trust companies to get there; the agency problem, through misalignment of time horizons and incentives, may lead to company management avoiding the necessary long-term decisions. Other companies have yet to make that commitment or do so only in vague terms. We believe active ownership, underpinned by in-depth research, is the only answer to these challenges.

The climate aim may at times conflict with the financial objective of the strategy. We have a long experience of managing funds with twin mandates in the form of an enhanced income and capital returns, where trades-offs have had to be made in sacrificing one over the other. It is often a judgement call, there are not always obvious answers nor complete information. This is not dissimilar from the financial objective and climate aims of this strategy; we make decisions on the basis of our process and experience and our best efforts to reflect the mandates faithfully.

INVESTMENT PROCESS

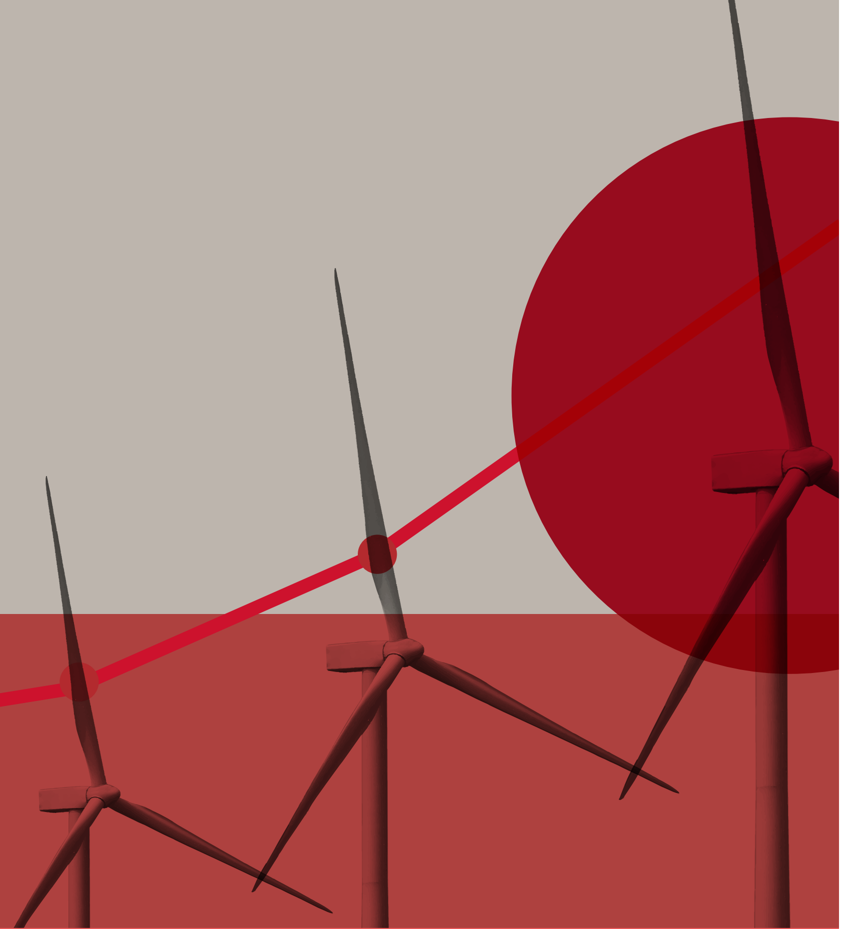
We are bottom-up, fundamental investors, with a strict valuation discipline and a long-term investment horizon. We believe that behavioural biases amongst many market participants causes them to overreact to news which has little or no impact on the long run value of a business. We also believe there are structural reasons that cause market dislocations. Such behavioural and structural forces can cause share prices to diverge from the intrinsic value of the underlying business and provides an opportunity for long term investors to purchase shares at less than their true value. In the long term the share price tends to move closer to the intrinsic value of the business and this creates excess returns for investors who purchased shares at low valuations.

We believe climate change and associated divestment is a special case of a behaviourally driven structural undervaluation in the market. The underlying reason for wishing to avoid carbon intensive companies is very persuasive and unifies many stakeholders, including many assets owners and allocators. The awareness of global warming and the connection with investments has increased immeasurably over the last decade and coupled with the incidental outperformance of low carbon-intensive, growth businesses, has led to divestment, exclusion or disregarding of large swarths of the equity market in a blanket, indiscriminate fashion. This is the opportunity. However, investing in these ignored companies is not without its risks as the world undertakes a massive, unprecedented energy transition.

Therefore, a bottom-up, company focused approach is integral to the achievement of the climate aim but also the financial returns goal. Each company is unique and requires careful individual analysis, but the basic investment process relies on the assessment of four main risks, these are 1) valuation risk, 2) business or earnings risk, 3) balance sheet risk and 4) ESG risk. The link to financial returns and climate change is inherent in each of these risks.

The valuation risk may be through paying too high a price for a company or may be a future structural shift higher in the discount rate due to risks associated with climate change, undermining long-term returns. The business or earnings risk is the assessment of the normalised level of earnings for a company and the risks attached to this assessment, including the ability of the company to operate in various climate scenarios. There is a risk for profit margins from competition and industry disruption, as well as carbon abatement costs, incremental research and development costs or other transition costs. Balance sheet risk arises from stranded assets (impairments of assets such as fossil fuel reserves, plant, property, or other assets), which impact shareholder equity and increases gearing ratios (with potential implication for credit ratings). High gearing limits flexibility and room for manoeuvre in an uncertain transition, while raising liquidity risk. ESG risk covers a wide range of non-financial risks, with governance being a particularly crucial assessment in the context of climate.

It is the large degree of risk associated with the energy transition and transition to low carbon businesses that makes the assessment of these four primary risks central to the investment process and suited to bottom-up analysis. The strategy results in a relatively concentrated, high conviction portfolio that may be materially different from the broader market at stocks and sector levels. The typical holding period for a stock is expected to be more than five years. All stocks will be subject to an assessment of their ability to align to net zero prior to investment, with carbon intensive companies subject to a more rigorous, in-depth assessment framework post investment.



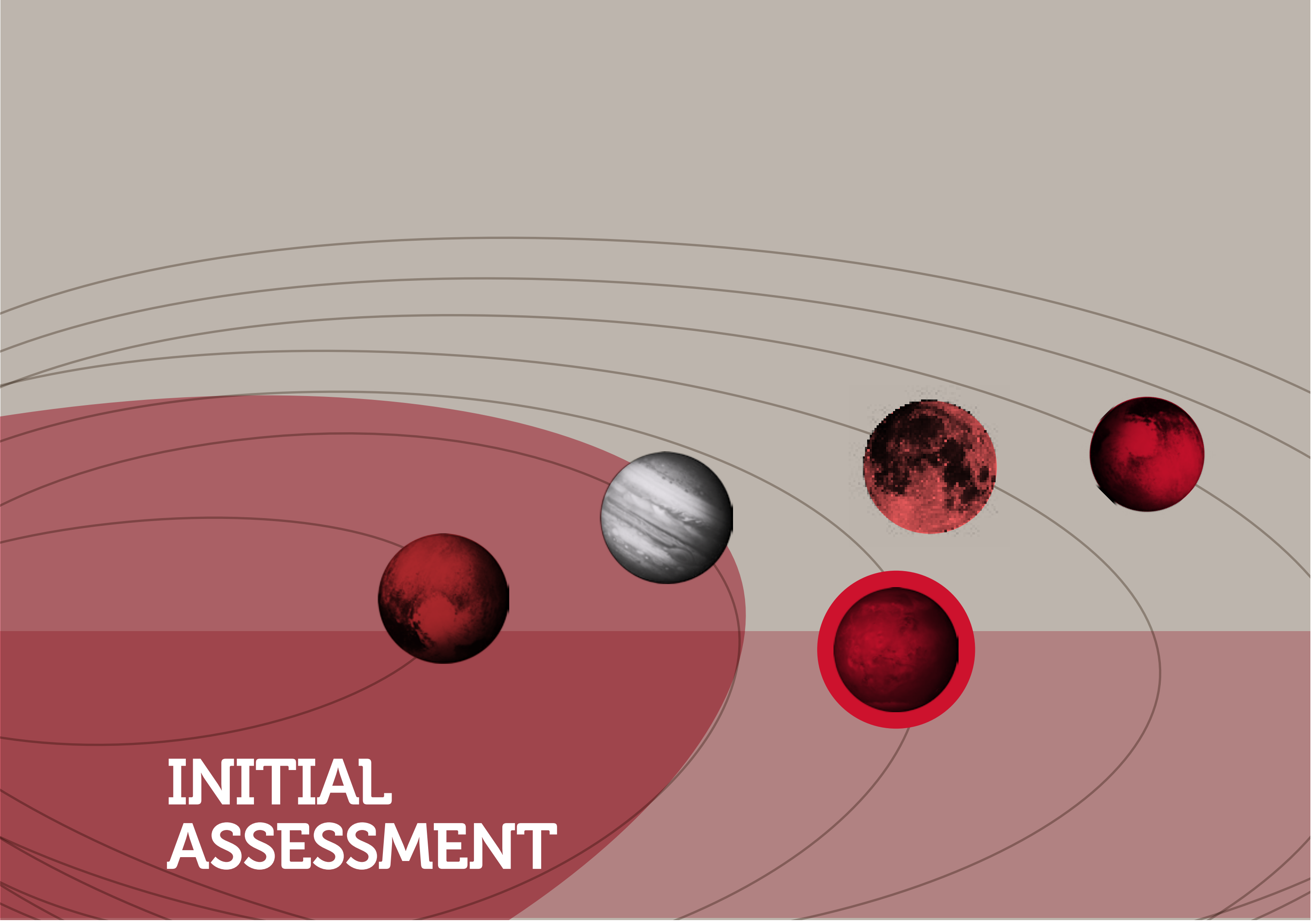
ENVIRONMENTAL, SOCIAL AND GOVERNANCE RISKS

The climate engagement objective is supported by the framework set out in this primer. However, environmental, social and governance risks are assessed as a fundamental part of the investment process. The strategy objective does not diminish the importance of assessing and if necessary, engaging on other environmental or social issues. There is an assessment made of such non-financial risks, drawing from experience, from the SASB® Materiality Map and from other sources including a company's own assessment. Governance is fundamental in underpinning climate objectives and creating long-term shareholder value. Please refer to the ESG guidance documentation for the Income & Value team for more detail on the generalised approach to ESG integration.

Engagement with companies on climate transition plans is a central focus of the fund. However, climate cannot be disentangled from social issues. Within the core climate assessment framework, a Just Transition is one of the ten factors assessed. A Just Transition includes the impact of transition plans on workers and communities. Mitigating climate change through using wind turbines or solar panels produced using modern slavery for example, is not acceptable[24], the Paris Agreement is clear on this point as signatories agree to take "into account the imperatives of a just transition of the workforce and the creation of decent work and quality jobs…"[25] Similarly, extractive companies cannot decouple their transition plans from social issues. A Just Transition also goes beyond workers and the immediate local community, through the value chain to include suppliers, customers, and other stakeholders.

In a UK context, a clear example of supporting a Just Transition through our engagement, is through encouraging retail banks to support residential energy efficiency measures. The UK has the oldest housing stock in Europe, and it accounts for 20% of the country's total carbon emissions.[26] Of existing dwellings in England and Wales, only 60% have an Energy Performance Certificate (EPC) rating and of those with a rating 42% have ratings of C or above.[27] Lower income households are more vulnerable to fuel poverty, defined as paying 10% or more of income in energy bills, (which depends on the interaction between energy efficiency, household income and energy prices) and more likely to live in non-rated or lowly rated dwellings. Before the energy crisis it was estimated that 12.5% of households would suffer fuel poverty, this figure is now likely much higher.[28] Therefore, improved energy efficiency helps alleviate fuel poverty, whilst having a direct link to the aim of reducing carbon emissions.

[24] theguardian.com
[25] unfccc.int
[26] cih.org
[27] ons.gov.uk
[28] Energy prices and their effect on households - Office for National Statistics (ons.gov.uk)



INITIAL ASSESSMENT

The strategy invests across the investment universe, it is not confined to carbon intensive sectors. In the context of the climate aim, an initial assessment for inclusion in the portfolio is the willingness or potential of a company to make a transition to a low carbon economy, and to align with net zero. The assessment does not rule out companies based on no stated intention to transition or commitment to net zero, the lack of such a commitment does however increase the challenge. A company's willingness to entertain such strategic changes can shift dramatically with a change of leadership and offers an even greater reward in both shareholder returns and driving real world decarbonisation.

We also need to assess a company's ability to transition, irrespective of their stated intention to so do. In some cases, the inability to make such a transition is more obvious, such as Thungela, the thermal coal mining company described earlier, while in others a more in-depth analysis is required before arriving at a conclusion. The strategy has adopted hard limits on thermal coal extraction and thermal coal power generation as thermal coal is the most carbon intensive fossil fuel and a priority to remove from the energy system. The IPCC said in a 2018 report that coal-fired power generation had to be reduced by 78% by 2030 to keep 1.5°C within reach.[29] As a strategy focused on developed markets, holding thermal coal is therefore very difficult to justify and can only be a marginal activity which is being run down responsibly.

1. Intention, willingness, or potential to transition
Has the company declared the intention to transition, or shown the willingness to do so; or does the business have the characteristics to transition (in the absence of declared intention or willingness)?

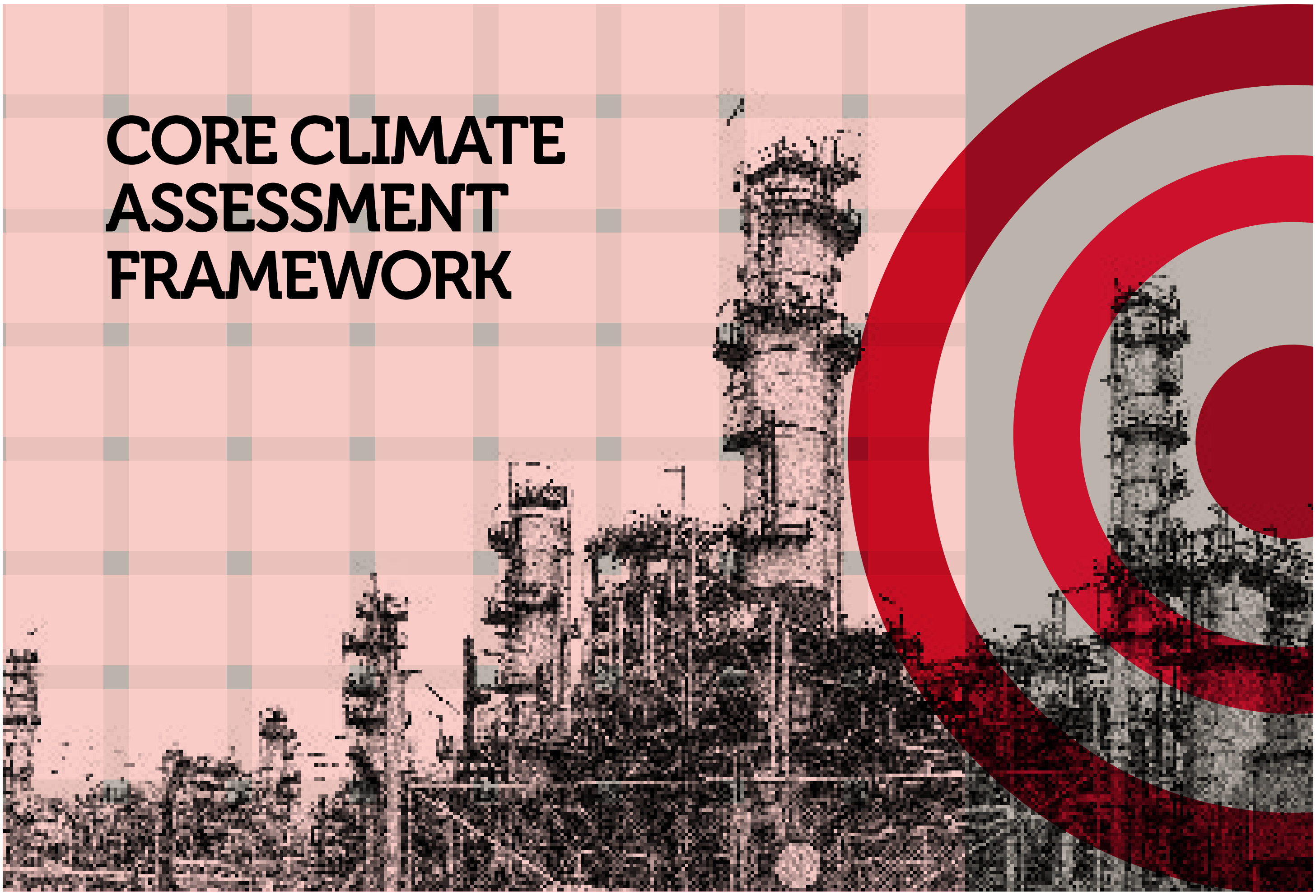
2. Ability to transition
A key assessment is the ability of the business to transition to a low carbon economy. Fundamental research and climate scenario analysis will help inform this assessment. The current business and path to a future low carbon business, management quality, balance sheet strength and cashflow characteristics are key areas to evaluate when assessing ability to transition.

Underpinning the sustainability credentials of the strategy, hard limits are applied as follows in respect of tobacco production and sales, as well as thermal coal extraction and power generation:

- Engage in the production of tobacco
- Generate 10% of more of revenue from the sale of tobacco
- Generate 10% or more of revenue from thermal coal extraction
- Generate 10% or more of revenue from thermal coal power generation

[29]coalexit.org

CORE CLIMATE ASSESSMENT FRAMEWORK



This foundational framework, developed by the IIGCC, guides stewardship to deliver the rapid acceleration in decarbonisation required to halve emissions by 2030 and put the world on course for Net Zero by 2050 or sooner. This framework forms the basis for our core climate assessment of the five to ten carbon intensive companies in the strategy. Investee companies falling outside of this group are also subject to a climate assessment with the aim of having their plans validated by the Science Based Target initiative or similar body. Using a recognised framework such as the IIGCC's allows us to leverage collaboration with other investors, and aligns closely with the CA100+ net zero benchmark. Based on the framework and in-depth analysis Key Performance Indicators (KPIs) are set for individual companies. The ten high level areas of net zero alignment are as follows:

1. Ambition
A long-term emissions goal based on Scope 1, 2 and material Scope 3 consistent with limiting the increase in global temperatures to 1.5°C with limited or no overshoot ("net zero").

2. Targets
Short- and medium-term emissions targets (for Scope 1, 2 and material Scope 3) should aim to be consistent with the trajectory implied by the long-term target and the science-based net zero Pathway (sectorial pathways)

3. Climate governance
The company should provide clear evidence of net zero transition planning (based on established targets, strategy and board oversight). Executive remuneration should be linked to delivering targets.

4. Emissions performance
Current emissions intensity performance on a metric consistent with targets should be disclosed and show a trajectory consistent with that needed to meet emissions targets.

5. Disclosure and verification
Scope 1, 2 and material Scope 3 emissions should be disclosed along with satisfactory review of the company's measurement and verification process

6. Climate risk and accounts
The company should provide disclosures on risks associated with the transition through TCFD reporting and financial accounts should state the climate scenario under which they were generated as well as any material, climate sensitive, assumptions (e.g., fossil fuel prices, carbon taxes) and outcomes (e.g., write-downs on coal assets, useful life impact on gas assets). Where assumptions are not consistent with a net zero scenario, the impact of a net zero scenario on financial statements should be indicated.

7. Decarbonisation Strategy
A quantified plan setting out the measures that will be deployed to deliver GHG targets, and the use of neutralising actions such as CCUS (Carbon Capture, Utilisation and Storage) and offsets are clearly disclosed.

8. Capital Allocation Alignment
Capital expenditure plans should be set out and consistent with the overall decarbonisation strategy. The methodology for determining any claims of alignment with net zero should also be disclosed.

9. Climate Policy Engagement
The company has a Paris aligned climate lobbying position and demonstrates alignment of its direct and indirect lobbying activities.

10. Just Transition
The company considers the impacts from transitioning to a lower-carbon business model on its workers and communities. This is a key assessment in linking climate change to social issues. The assessment of a Just Transition in the context of a corporate's transition plan is currently evolving. CA100+ have developed a beta version but are yet to publish company assessments on the factor. This is an area where Greenwheel supports the investment team in developing an appropriate assessment framework.

The IIGCC have also developed sector specific alignment criteria, and this supplements the standard framework.

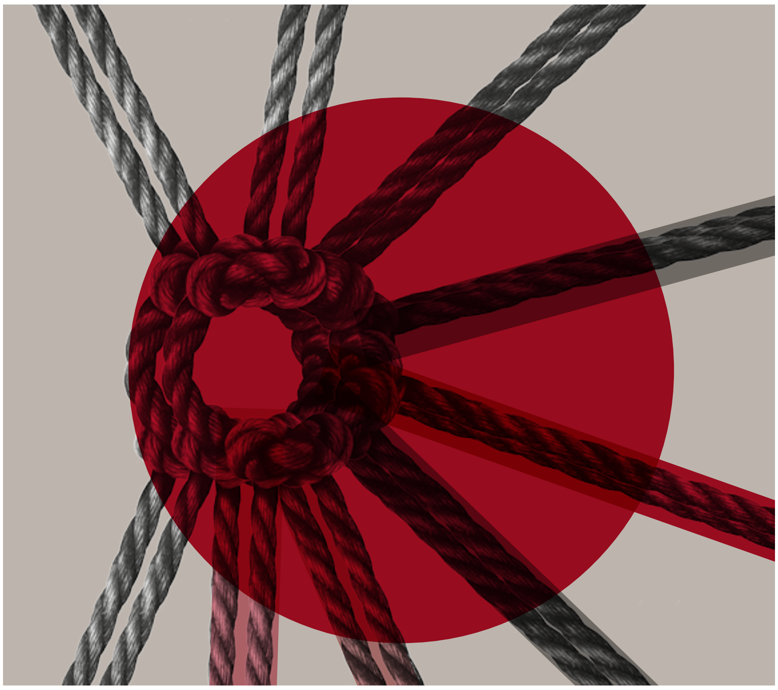
Photograph by Getty Images

"Engagement with companies on climate transition plans is a central focus of the fund. However, climate cannot be disentangled from social issues. A Just Transition is one of ten factors assessed.."

Under each assessment heading is further detailed work, for example targets are assessed versus a relevant sectoral pathway. The difference between sectorial pathway guidance on emissions reductions and a company's targets, offers an obvious area for engagement. While those targets are important, net zero alignment is not adjudged on one factor alone, aligned targets in themselves are arguably insufficient if the underlying strategy, climate governance and capital allocation do not support those targets. The assessment may also focus engagement on what becomes apparent as the most important decarbonisation levers available to an individual company. On scope 3 for oil and gas companies, for example, the decarbonisation plans of major clients may be the most impactful lever such companies can pull to unlock the lack of emission reductions in the value chain. The assessment may deem that a company is genuinely struggling to move onto an aligned pathway due to a public policy gap, the emphasis of the engagement will then shift to understanding that gap, getting a company to detail the specific policies required, and then monitoring a company's climate policy engagement i.e., its positive lobbying to close the policy gap and get those specific policies implemented.

Key performance indicators are set for each carbon intensive company where alignment has not been achieved. If alignment is achieved, then progress on annual emissions reductions and progress on business transition plans are monitored to ensure compliance. KPIs with respect to alignment are unique, focusing on areas of weakness as highlighted in the core climate assessment of each company. For example, a KPI may involve increased ambition on targets, greater disclosure on scope 3 emissions, improved TCFD reporting, greater alignment of incentives with emission reductions, publication of capital expenditure plans to support the transition and reporting of green revenue to demonstrate progress. The timeline for KPIs will vary, the timeline on achieving incentive alignment will recognise that policies are updated every three years, other objectives have shorter or longer time horizons reflecting a reasonable timeframe to get the message across to a company and for a company to subsequently act. Success will be measured as an improvement in the core climate assessment of a company and thus bringing a company closer to net zero alignment.

For now, incorporation of scope 3 considerations remains the ambition, but we do recognise that there are practical barriers to doing so. Corporate disclosure of Scope 3 emissions (the emissions associated with the value chain) remains patchy, and the calculation and accounting mechanisms remain prone to duplication. For instance, to which companies should the emissions arising from driving a car be attributed and in what proportion: these need to be shared out between the auto manufacturer, the fuel producer, the fuel supplier, and any other participant in the value chain. Nonetheless, an appreciation of the potential significance of scope 3 emissions is vital in the context of encouraging companies to account effectively for their contribution to global warming and the achievement of global policy goals.



ENGAGEMENT

The strategy is about active ownership, and engagement with companies is the most fundamental part of this strategy. We aim to be constructive partners to our investee companies. Acting as owners, we seek to support directors in making the right decisions to progress transition plans, in helping them understand the weaknesses of those plans and to help them understand better the evolving demands of capital allocators and the capital markets. At times the conversation between companies and investors can be distrustful, confrontational, and ill informed. We try to make engagements holistic, putting transition plans into the context of investor demand for the shares of a company, the increasing capital flows to ESG funds, and the changing expectations of capital allocators with respect to their own climate commitments.

To ensure an engagement is both relevant and meaningful, it is therefore our first responsibility to take time to inform ourselves, to understand the company and understand the business, before making demands of a company. This knowledge building will entail bottom up, in-depth financial and non-financial research and then listening to various management levels and various functions within a company.

We believe a big advantage to our approach is that the engagement is led by the portfolio manager because to divorce non-financial issues, such as climate, from the financials of a company does not make sense. We cannot ask our investee companies to do things for which they do not have the financial capacity, or we must acknowledge the appropriate speed with which they can act in a financially prudent manner. To force companies to act without recognising the implications on financial stability or competitive positioning, may undermine their long-term survival, while doing nothing to reduce global emissions. This is not an excuse for in-action, rather the need to calibrate the approach to support a successful transition and a successful company.

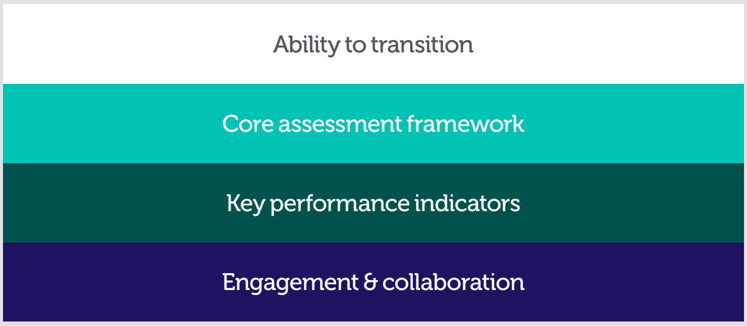
While the core climate assessment framework is central to our assessment of a company, we see access to directors and speaking truth to those directors as key change enablers. Executive directors need to understand the changing profile of capital allocators, the growing valuation gap between high and low carbon intense companies and the reward for demonstrating progress, this should help provide context to support improvement and create incentive. Non-executive directors (NEDs) can benefit from an aligned, but independent voice to inform them more fully on their own company's transition plans. A non-executive director may find it difficult to challenge the position of management, there is an asymmetry of knowledge and most information a non-executive receives comes from the management team.

As holders of a company's shares, we have a clear alignment with NEDs in pursuing value creation, but we have the independence from management to offer a credible alternative assessment of management's strategy. Speaking with the chair, the senior independent director, or an independent director with board responsibilities for climate issues, allows us to get our views into the boardroom and thus to challenge management where we disagree with their position. Getting our viewpoint into a board discussion is thus considered a real success for our strategy. We have achieved this in several instances, including Shell, Centrica, Barclays, and NatWest Group.

In addition, there is another role we play in assessing certain claims of progress, or assessment of products or services a company offers to burnish their green credentials. Greenwashing is unfortunately a part of the corporate world, thus if we see evidence of greenwashing, it is part of our responsibility to call it out. Shareholders may feel conflicted in calling out greenwashing for fear of damaging the value of their investments, we see it as improving genuine alignment with net zero, risk reduction in terms of reputation, or regulatory and legal risks, and a duty to our clients to avoid being complicit in such greenwashing through our silence.

It is not always clear where the line is between greenwashing and a legitimate signalling of intent; having an open, honest, and often hard conversation with directors about a claim, product or service will ensure directors are fully aware of the risks they are running. Examples include claims of big GHG reductions based on dubious carbon offsets or use of dubious 'green' electricity certificates (such as unbundled renewable energy certificates and guarantees of origin), and products or services that are used to project the 'green' credentials of a firm but are little more than a marketing campaign and a fraction of a company's annual marketing budget. Helping companies make only genuine green claims or offer genuine green products and services can be a real success for the strategy in supporting overall progress in alignment with the goals of the Paris Agreement.

Credible targets, backed by credible plans, underpinned by credible governance



Engagement topics are developed based on the assessment of alignment and the progress on KPIs identified through the core climate assessment framework, along with other non-financial issues outside of climate that are material for an investee company. Engagements are also used to acknowledge progress that has been made, to ensure directors feel appreciated in the work they have done and encouraged to continue in making progress. Companies may externally appear united in vision and strategy; the truth is usually the opposite with various internal stakeholders and factions pulling in different directions. Companies that have made the transition, such as Ørsted, have borne witness to the internal disagreements over transition plans.[30] It is therefore important to voice shareholder support for progress made and thus support management in their internal struggles. Having clear shareholder support is very powerful within internal discussions.

Generally, we wish to keep engagement constructive, however escalation of engagements is often required to gain the attention of a company, to ensure they are listening to us and understand our point of view. Therefore, when progress is not as expected, an escalation mechanism is employed. The escalation mechanism is not rigidly prescriptive as progress will require varying levels of escalation and de-escalation. However, the following is an example of the possible steps as escalation progresses:

1. **Letter to the Board Chair outlining problematic issues**
2. **Additional meetings with board (Chair of the board, Director with Climate/ Sustainability responsibilities, Risk/Audit Chair, Senior Independent Director) or management (CEO, CFO, Head of Climate/Sustainability)**
3. **Expressing concern via AGM by voting positions on:**
   a. Transition plans
   b. Remuneration report
   c. Re-appointment of the Auditor
   d. Re-election of directors (focus on Audit, Risk and Sustainability Committees)
4. **Increased collaboration with other shareholders to highlight problematic areas**
5. **Sharing of analysis with other shareholders to raise awareness of issues**
6. **Expressing disagreement via AGM voting:**
   a. Pre-declaring voting intentions
   b. Sharing views more publicly
   c. Against re-appointment of the Auditor
   d. Against re-election of CEO
   e. Against re-election of Chair

Assessment of the situation, the potential for progress, (may result in review of stock position size or entire holding), is an exercise undertaken at various points through the escalation process.

We may also support shareholder proposals. Such support may not always indicate escalation of our engagement or criticism of management or their overall strategy. Neither do we commit to supporting all shareholder proposals on climate. Each vote will be considered in the context of the target company, their progress and our live engagements and collaborations.

We do not view divestment as part of the engagement or escalation process as it effectively ends engagement and is not a bridge to further action. Neither do we view it as the ultimate sanction because as a sanction it is much less effective than most other levers including voting against directors, against remuneration or collaborating with other shareholders and raising the awareness to a wider audience.

We believe company management and directors are much more likely to move because of their positive interaction with shareholders, or from an understanding of the implicit or explicit threat to individual positions, remuneration, or bad press. Divestment is a last action to take; it would mean there was no course open to us to push change on the company. It is a sign of failure. It is a failure to recognise at the outset that the company would not or could not align and a failure to convince the company over time to change course, directly or in collaboration, and a failure to use the levers of remuneration, director re-election or public communication to force change.

Furthermore, divestment makes no difference to a company in terms of their alignment plans. We simply sell the shares to another investor, who potentially cares less than we do.

It is understandable that our shareholders would want to see action, and divestment is seen as a very strong, bold action. We encourage our shareholders to view it in a different light. This is not an excuse to remain invested in every carbon intensive holding, a justification for remaining invested in all our carbon intensive holdings will be delivered through the in-depth assessments, engagements, collaborations and voting, and the future strategy to elicit change. While we have a long holding period, we do sell companies for many reasons and progress on climate will be a very important consideration for this strategy, but we do not see it as a means of getting a company closer in alignment to net zero.

[30] A tale of transformation: the Danish company that went from black to green energy | Corporate Knights

RISKS & OPPORTUNITIES

There are many uncertainties relating to climate change and the transition to a low carbon world. These uncertainties and how they develop will influence the success of the strategy. Whilst we believe there is a structural undervaluation of carbon intensive stocks, a major support in meeting the financial return objectives, there is also a high degree of risk in the transition. The risks may materialise in a financial manner or in relation to the success of the climate aim. The risks include:

1. The climate goal may impact the performance of the strategy both positively and negatively. Identifying companies that can successfully transition and who subsequently gain recognition from the market for this ability to successfully transition, may result in a valuation uplift, improving returns.

   However, divesting from companies based on a change in the assessment of the ability or willingness of a company to transition or on their progress on the KPIs, may result in a capital impairment, should the company be sold from the portfolio on that basis and irrespective of valuation.

   The performance may also be negatively impacted if companies are asked to incur costs or take voluntary action: which do not have a financial benefit for the firm; the benefits are not within the investment horizon of the investor; are not recognised by the market as we anticipated; or put the company at a disadvantage to competitors not taking the same action.

2. Policy is a major risk associated with achieving Net Zero alignment. A policy gap is likely to undermine a transition pathway. If government policy fails to align incentives to support net zero requirements, there is a risk that voluntary action imposes a cost on companies, with no future benefit. It may therefore limit a company's ability to make progress and our ability to push them to do so. In Section One we stated how current policies and action are estimated to align with a 2.7°C world. Put another way, there is a 90% chance of exceeding 1.5 °C by 2100.[31] We therefore recognise the important role for positive lobbying by investee companies in a bid to unlock this problem. We also see a role for investors to increasingly engage, primarily through industry groups, in lobbying for public policy action.

3. The climate science may evolve over time in terms of temperature pathways or timescales required to limit global warming. There remains uncertainty for example around the global warming potential of methane and other greenhouse gases and there is also uncertainty as to the level of methane leakage. Changes to our understanding of the science, may change the outlook for companies, in this instance gas producers. It may influence the focus, goals, or expectations of investors with regards to the energy transition. We will continue to monitor the latest climate science supported by our Greenwheel research team and will incorporate these insights into our approach as appropriate.

4. It is challenging, often impossible, to prove within listed equities that an investors engagements, collaborations, and voting have elicited change within a company. This may disappoint our shareholders. However, as the Center for Sustainable Finance and Private Wealth pointed out, an obsession with verifying our individual contribution may be a block to greater impact, "A narrow focus on easily measurable indicators may stand in the way of maximising impact. It may prioritise an investor's resources to challenges with easily quantifiable indicators and underappreciate indirect effects that are difficult to assess."[32]

   We hope these fears are allayed by the formal inclusion of a climate aim, the deep transition research we conduct, our engagements and collaborations, and use of proxy voting. Through extensive reporting we hope shareholders gain further confidence in the genuine commitment to deliver on the aim.

The tools, frameworks, and data available to investors focused on the energy transition are likely to evolve over time. We will track these developments closely, particularly leveraging the knowledge, insights and networks of our internal sustainability experts, our relationships with key industry groups (e.g. IIGCC, PRI, Climate Action 100+), and incorporating relevant innovations into our toolkit as they emerge. We envisage such developments will improve our own processes.

We described some of the opportunities in Section One. The power sector has thrown up many of the transition opportunities over the last decade. We believe the energy sector can follow a similar path. Notwithstanding the emergency that is climate change, these companies understand that fossil fuels will be phased out (albeit the timing is uncertain) and that their businesses are at risk. In their own interests they will develop new lines of low carbon businesses. In addition to this deep motivation, they are often best placed to develop alternative products or to decarbonise the manufacturing processes in their sector. We believe that pressure from shareholders motivated by climate change, supports and encourages this progress. By pushing companies to undertake such exercises as scenario analysis, and pressure to improve on this analysis from one year to the next, highlights not only risks, but future opportunities for carbon intensive companies. Those companies that move with this knowledge, may develop a competitive edge over slower moving competitors and as regulation tightens and consumer preferences become more oriented to mitigating climate change, that advantage could become very significant. We have seen this already, where the pressure of client preferences and a corporate decarbonisation mission has fed down through the supply chain. Enel is one example, incorporating their suppliers in their circular economy programme, with decarbonisation as one of the key pillars of that programme.[33] To reiterate the point we made in Section One, financial strength and liquidity are crucial characteristics we look for in companies, to deal with the risks and to take advantage of the opportunities, as the transition progresses.

[31] climateactiontracker.org
[32] Center for Sustainable Finance and Private Wealth
[33] enel.com

SELL DISCIPLINE

We may divest a company based on valuation; on changes in financial or material non-financial risks; where it becomes apparent the transition plans are not credible, achievable, or progress on KPIs is insufficient; where the original thesis has changed; or where a more attractive investment/transition opportunity arises. Our typical holding period is over five years.

While we will divest a stock if progress on climate aim KPIs is insufficient, we do not see such divestment within the context of escalation or as part of the engagement strategy, as it does not lead to further action and effectively ends engagement. The divestment threat will implicitly be understood by investee companies, just as it is on financial and other non-financial issues. However, the act of divesting shares in the secondary market, simply transfers shares to another owner.

VOTING POLICY

Our ability to vote at AGMs, along with engagement, form the core part of active ownership underpinning the strategy's climate aim. Voting is a fundamental lever for change. Voting on directors' re-election, company policies and plans can have a major impact on the behaviour of a company. We believe voting has a vastly bigger impact than selling out of a company's shares.

The annual general meeting is the point in the year when we step back and assess a company in the context of the climate aim. This assessment is based on the core climate assessment framework, the linked KPIs and the progress of our engagements and collaborations. We decide at this point if a company, in the guise of voting on the various resolutions, deserve our support or whether we cast our votes to send a clear message on a specific issue, or of overall dissatisfaction with a company's strategy.

As per the core climate assessment framework, we focus on ambition, targets, governance, disclosure, reporting and lobbying. Our votes will link the assessment and the appropriate resolution. For example, on overall strategy and ambition the link is to the transition plan (Say on Climate vote) and the re-election of the chair of the board and may progress to the re-election of other directors. On climate governance linked to alignment of incentives, the focus is on the remuneration report, remuneration policy and the chair of remuneration committee. We believe votes on re-election of directors and on remuneration are the two of the most effective votes in our bid to influence a board. The UK Corporate Governance Code 2018 requiring an update statement within six months of the AGM for a protest vote of 20% or more, and The IA Public Register recording such votes, incentivises directors to avoid this public embarrassment. We do not need majority votes to exact change from a company.

As part of our escalation strategy, we communicate our voting decisions in various ways. Where we are a major shareholder and it represents a key issue for us or a very sensitive issue for the company, we communicate our voting intention to the company ahead of the annual general meeting. Where we may have less of an influential shareholding, but it is a key issue for us, we communicate ahead of the AGM to maximise the company's awareness of our position. When we feel progress is not being made or management is not engaging with us, we may decide to pre-declare our voting intention ahead of the AGM. We have done this on several occasions including on Shell, when we publicly supported the Follow This shareholder proposal at the 2021 AGM[34], and Barclays when we voted against their transition plans in the 2022 AGM.

Our voting decisions are based on our own research and engagements, while we do reflect on the recommendations of the ISS Climate Voting Policy and will closely listen to the views of other well-informed shareholders.

[34] Royal Dutch Shell investor RWC to back Follow This climate proposal at AGM | Reuters

TRACK RECORD

We have engaged extensively with our investee companies over several years on the issue of climate change. This enhanced engagement was driven by our increasing awareness of the importance of the issue, the need to improve our own understanding of climate change and the science behind it, the impact it was having on our investee companies and the additional risk it meant for our portfolios. We have pursued various means to improve our own knowledge, engaging with experts both within investee companies and outside, with investor networks, collaborative initiatives, NGOs, and other formal and informal networks offering climate expertise. We have also been pushed to increase our understanding by our clients, who ask questions on the topic more frequently and in greater depth with each passing year.

Our energy holdings have been the dominant focus for engagement to date, followed by individual companies within energy distribution, basic materials, and banks. Oil and gas companies are in the epicentre of the divestment debate, with endowments, pension funds and private investors choosing to sell or avoid their securities. To retain a social licence to operate and remain investible, these companies must become part of the solution. They have made progress; the European majors among integrated oil and gas companies have taken climate change seriously. They have made real progress in ambition, disclosures, and climate governance.

However, progress while very welcome, has not always been sufficient, and we have used our vote to send that clear message. In 2021, we voted against Shell's transition plans and for a shareholder proposal demanding more ambition. Communicating our reasons for these votes to Shell, and pre-declaring our position publicly as mentioned in the voting section, led to a deeper engagement with the company, including meeting the CEO and Chairman. We also joined the CA100+ Shell collaboration, which has allowed us to hear the views of other shareholders and push together for improvement. Our further engagement brought us to the conclusion that new leadership was required to take Shell on the next stage of their journey and communicated this to the chairman directly and via our voting on the re-election of the CEO at the 2022 AGM. We do not claim that our voice changed succession plans, but multiple shareholders speaking to the company is a powerful influence, with a new CEO taking the helm in 2023.

We have also engaged intensively with Centrica, the owner of British Gas, the largest of the big six energy suppliers in the UK. Centrica also retains some upstream assets, electricity generation assets and exposure to nuclear power through its stake in Britain's nuclear fleet. The biggest challenge for the company is the decarbonisation of heat, how to phase out gas in residential heating. The company has made huge progress in developing transition plans, but again much more progress is required leading us to vote against their transition plans at the 2022 AGM. We communicated this to the company and were invited to join the CA100+ Centrica collaboration as a co-lead.

Financial companies are another area of focus for us. Whilst banks themselves are not operationally carbon intensive businesses, they finance and facilitate investment in fossil fuels. They have a major influence on the transition as they supply capital directly to companies, unlike shareholders in public markets who predominately are trading shares with other investors. On the request of the company, we supported Barclays in 2021, voting against a shareholder proposal. They sought time to develop their plans and offered a 'Say on Climate' vote on those plans for 2022.

We were disappointed with the outcome, the high-level aspiration was undermined by the detail, and thus it felt that it was business as usual. We communicated our views to the company, pre-declared our voting intention, voted against their Climate Strategy, Targets and Progress report and we shared our analysis with over one-third of the company's shareholder register.

Post the annual general meeting, we again engaged with the company and discussed in detail our critique of their plan. This has led to further and more in-depth engagements, including meeting the chairman.

Our voting record is available to all our shareholders, along with the justification for our decisions. We also provide a detailed annual stewardship report to explain at length our engagements.[35] We believe that active ownership, demonstrated here in engagement, collaboration and voting is a very powerful, if unglamorous approach to eliciting change from our investee companies.

RESOURCES

We believe that more than a core investment team is required to deliver a mandate such as this climate engagement strategy. However, we also believe there is a great advantage to the Redwheel structure where the investment team leads the engagement strategy, combining the financial and non-financial analysis, engaging with companies, and deciding on voting positions. This avoids a disjointed approach where these responsibilities are siloed into separate departments and decisions made without financial context. This Redwheel approach relies on supporting functions that are well integrated into the process.

The development of Greenwheel and growth of the Redwheel Sustainability Team is integral to the success of the strategy. This expanding resource represents the specialist expertise within Redwheel promoting and supporting the delivery of stewardship and sustainability in practice. Their insights and knowledge about client, market and regulatory expectations in relation to responsible investment, as well as their familiarity with the wider responsible investment community and the fast moving conversations taking place within it right now, have been and will remain key inputs to the development of our approach.

Furthermore, the strategy can innovatively leverage other Redwheel resources; the sales team acts as a conduit to relay key climate assessments to peers, who may themselves have avenues open to them to apply pressure on the target company. We employed this successfully in our Barclays escalation in 2022. The marketing team help to open broader communication lines, which can play a key part when pre-declaring voting positions and getting greater awareness of the specific positions. Such broader communication may be used in the context of positive lobbying on policy.

The investment team draws on numerous external resources including broker research, service and data providers such as Bloomberg, Sustainalytics, S&P Capital IQ, ISS and non-profit resources such as CDP, ClimateAction100+ (CA100+), Carbon Tracker, SASB, Science Based Targets initiative (SBTi) and Transition Pathway Initiative (TPI). The main formal collaboration platforms include CA100+ and the Investor Forum. Membership of The Institutional Investors Group on Climate Change (IIGCC) provides access to best practice, education, and networking opportunities. The team also draws on specialist climate research to support in-depth analysis of carbon profiles and transition plans, working closely with Accela Research, a dedicated, not-for-profit, climate transition research and advisory group. Accela Research provides bespoke reports on individual holdings, with this research prompting well informed and targeted engagements with investee companies

John Teahan, lead portfolio manager

The Investment Team
The strategy is managed by the UK Income & Value Team, John Teahan is the lead portfolio manager. John is supported by Nick Purves and Ian Lance, the portfolio managers on the UK equity strategy.

John is a partner at Redwheel and, along with his fundamental research and portfolio management duties, he leads on responsible investing for the team. He developed the ESG framework and is responsible for ESG research, engagements and collaboration. He joined Redwheel in 2010 and previously worked as a portfolio manager at Schroders.

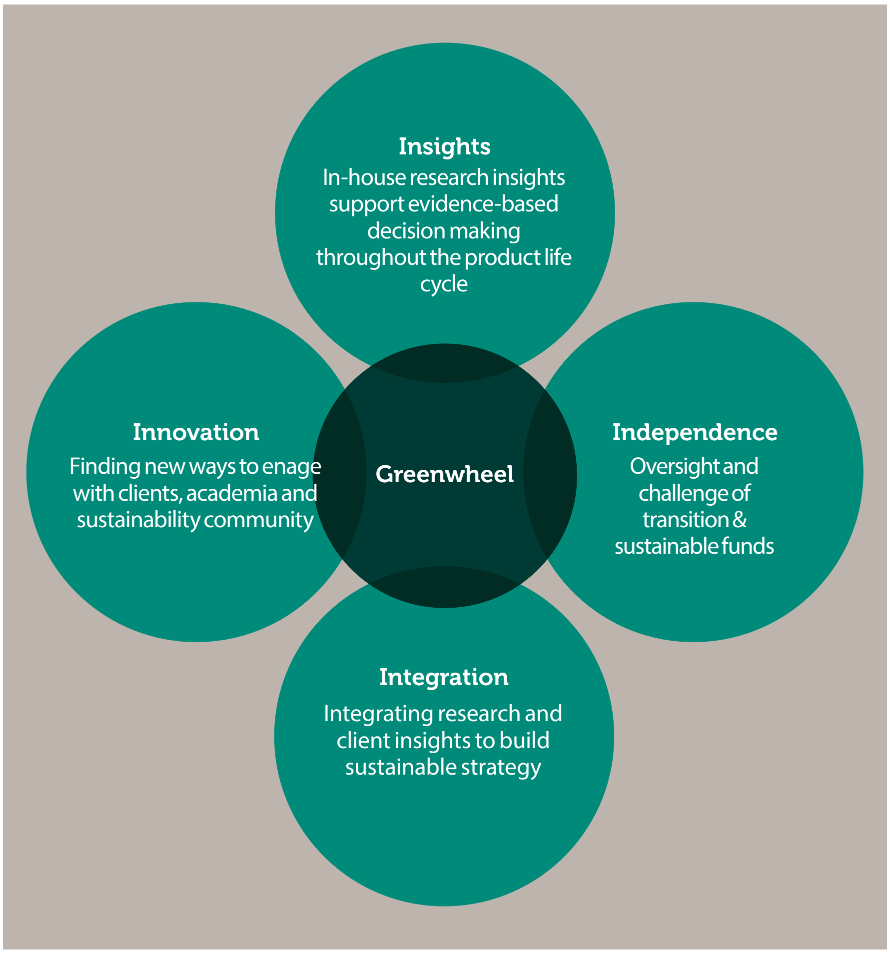
John volunteers for the CFA UK and was instrumental in launching the CFA UK podcast series on Climate Change, which he currently hosts. He was recognised by the Investor Forum for his engagement work with UK banks on climate issues and was selected as an ESG Champion by the National Resource Forum, for "outstanding contribution in driving forward innovation, education and enacting real change in the implementation of ESG policies and strategies across the industry". He is a CFA Charterholder and holds an M.A. from Trinity College Dublin. He also holds the CFA Certificate in ESG Investing and the CFA UK Certificate in Climate and Investing.

Larry Furness and Shaul Rosten are analysts on the team. Larry is a CFA Charterholder, holds the CFA Certificate in ESG Investing and a BA in Economics from the University of Nottingham. Larry joined Redwheel in 2010. Shaul has a B.Sc. in Biological Sciences from Imperial College London. He joined Redwheel in 2022 and previously worked at Man Group.

[35] redwheel.com

Greenwheel
Greenwheel integrates thematic research insights, sustainability strategy and independent challenge to support responsible, transition and sustainable fund management at Redwheel every stage of the product life cycle from initial product scoping right through to day-to-day investment decision making.

In practice, this means Greenwheel supports investment teams in developing best practice frameworks to assess sustainability factors, from assessing climate and environmental factors such as net zero alignment, to social factors such as modern slavery and human rights. The team was central in the development of the UK Climate Engagement strategy, helping to create the core climate assessment framework and overarching climate aim of the strategy. It remains a crucial source of ongoing empirical and commercial insight, challenge and oversight to the UK Climate engagement strategy on an ongoing basis.



The team is led by Stephanie Kelly, who is responsible for overseeing and integrating both sustainability insights and strategies. She joined Redwheel in 2022 from abrdn, where she was Deputy Head of the Research Institute responsible for macro ESG research and political risk. Stephanie is a regular commentator on broadcast and print news media, with a particular focus on the political economy of climate policy, diversity and inclusion and the just transition. She represents Redwheel as a member of the LSE Grantham Institute Financing the Just Transition Alliance.

Olivia joined Redwheel in 2022 and is focused on bringing the evolving client, regulatory and market perspective to build a strong sustainable product suite and developing strong relationships with the external RI, stewardship and academic communities to maximise insights, innovation and rigor.

Prior to joining Redwheel, Olivia was Head of Engagement at Somerset Capital Management.

Olivia studied at the University of Cambridge and the London School of Economics and Political Sciences.

[36] naturalresourcesforum

Sustainability Team
The Redwheel Sustainability Team supports investment teams on ESG integration, policy development, communication and on data and reporting. The Team also facilitate engagement, collaboration both formal and informal, and proxy voting. For the UK Climate Engagement strategy, they additionally support the fund manager in the CA100+ collaborations as required.

The team is led by Chris Anker who is responsible for leading the planning and implementation of responsible investment processes within Redwheel, and also for overseeing corporate initiatives on sustainability. He represents Redwheel as a member of the Investment Association Sustainability and Responsible Investment Committee, the PLSA Stewardship Advisory Group, and is the focal point for Redwheel's involvement in other initiatives such as the Investor Forum, Institutional Investors Group on Climate Change, CDP, the Independent Investment Management Initiative, the UN PRI and the UN Global Compact.

Chris joined from Columbia Threadneedle Investments where he held the role of Senior Analyst, Responsible Investment Policy. He has over a decade of experience in the fields of corporate governance, stewardship, ethical investments and sustainable ownership. Chris has also worked in responsible investment roles at RPMI Railpen and the Church of England, having studied at the University of Oxford and Imperial College London. He is supported by Senior Sustainability Specialist Olivia Seddon-Daines and RI Associate Kathy Velasquez Rodriguez.

Kathy joined Redwheel in 2022 to help develop our quantitative analytical capabilities in relation to responsible investment. She previously worked at La Française Group within the Sustainability Investment Research team. Fluent in English, Spanish and Italian, Kathy has studied at both the Catholic University of The Sacred Heart in Milan, and the NOVA Business School in Lisbon.

Reporting
Investors in the strategy receive quarterly qualitative updates on the progress of key engagements and the key voting positions taken during the AGM season. Investors also receive quantitative data on carbon emissions, engagement activity and voting. A Stewardship Report is published annually.

Sustainability
A committed organisation, focussing on the long-term

Signatory of:

CONCLUSION

"Advocating for and supporting the acceleration of high-emitting companies' transition plans through stewardship activities will be among the most impactful actions that investors can take." UN PRI

We believe there is need for an evolution in product offerings to reflect the seriousness of climate change and the change in asset owner and beneficiary preferences. There already has been much development, however most new products have focused on climate solutions or the exclusion of carbon intensive sectors. We believe that one important omission has been the role investors can play through engagement with harder to abate sectors. The importance of this 'transition/improvers' mindset is reflected in the FCA labelling consultation.

Rather than divesting all carbon intensive companies in a blanket fashion, the focus is on changing these carbon intensive companies through active ownership. We believe it is more powerful to engage with companies, or if necessary to divest a company of its management, than to divest a company's shares from our portfolios. We also believe that leveraging the financial resources and engineering skills of large companies can be hugely positive for speeding up the transition. Climate solutions offered only by purely 'green' companies, cannot be expected to scale up within the timeframe or degree required to halt global warming in line with the ambition of the Paris Agreement.

The emphasise on climate change does not detract from other sustainability issues, the integration of ESG factors builds on what is already an in-depth framework focused on materiality. Climate change has direct links to social issues, and these are assessed in the context of a Just Transition, as envisaged by the Paris Agreement.

Traditional mandates are limited on what they can do by the sole objective of financial returns and fiduciary duty. A specific climate aim allows for climate to have greater bearing on portfolio decisions and on investee company engagement.

The probability of exceeding 1.5°C by 2100, based on binding targets, is estimated at over 90%. This demonstrates the gap in policy, inadequate targets, and lack of action from governments around the world. The UNEP Emissions Gap Report 2022 and lack of progress on fossil fuel removal at COP27, highlights the challenge in keeping the 1.5°C ambition, and even the 2°C target, alive. Companies operate in this context and thus they may not be able to achieve net zero alignment, without undermining the sustainability of their own businesses. We will not push companies to take action that will clearly imperil their survival; to do so would be counterproductive, busting companies, hitting economic growth, potentially exacerbating social problems, while not mitigating global warming. Mindful of this backdrop, we will push companies to accelerate decarbonisation towards Paris alignment and crucially where policy gaps to Paris Alignment persist, we will push companies to try to unlock barriers through lobbying and co-operation to make such alignment possible in the future. The policy gap is not an excuse for inaction.

Success is therefore improving investee companies' alignment with the goals of the Paris Agreement as evidenced by improvements on the core climate assessment framework, a framework based on the IIGCC Net Zero Investment Framework. Where there is a barrier to progress due to the policy gap, success is defined in getting a company to actively lobby for policy changes and still showing progress towards decarbonisation.

Success is incentivising management to improve plans, not just through remuneration policies, but through a better understanding of developments in capital flows, which are becoming 'greener' and more 'sustainable' oriented. Success is also defined by getting our views into the boardroom, triggering robust conversations among directors, and allowing non-executive directors to challenge management with alternative, well informed points of view. We also endeavour to keep corporates honest in the 'green' claims they make on plans, products, and services, to be a voice against greenwashing, this is also a success when we wake directors up to this risk and make them more genuine in what they do and what they claim to be doing.

The Redwheel UK Climate Engagement strategy follows a bottom-up, fundamental approach to assessing companies on both financial and climate factors. The long-term investment horizon is well suited to the in-depth research, engagement and collaboration required to bring about change within carbon intensive companies. The strategy offers to its shareholders, and prospective shareholders, a means of allocating capital in a manner that can have some genuine influence on decarbonising the real world and having some tangible influence on aligning companies with the goals of the Paris Agreement.

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