A LETTER FROM OUR SENIOR PARTNER

MARCH 2022

The next global crisis is upon us. The objective of limiting global temperature rise to 1.5C is on 'life support'.[1] Ensuring a just transition is not guaranteed. Urgent action is required.

At COP26, the finance sector committed $130 trillion[2] to the net-zero transition. To fulfil that commitment, finance must lead with or without government policy. We clearly need a financial system in which all financial institutions and capital allocators integrate climate and justice in their decisions across all asset classes. The window for action is now.

Together, we know *what* needs to be done. Our 2022 Senior Partner Letter will focus on the *how*.

We follow with our firm update.

[1] Secretary-General of the United Nations, António Guterres.

[2] We use the $130 trillion figure while recognising the credibility questions raised and note the figure underscores the significant risk of greenwashing.

HOW THE INVESTMENT INDUSTRY CAN ACCELERATE ACTION TO LIMIT GLOBAL TEMPERATURE RISE TO 1.5C AND ENSURE A JUST TRANSITION

We propose three pillars of action: Invest; Ensure a Just Transition; and Measure, Report and Engage.

1. INVEST

We must expand what the capital markets value.

The transition to net zero is urgent and a significant capital allocation problem. Aligning with a 1.5C world requires that we halve greenhouse gas (GHG) emissions in the next eight years and that we achieve net-zero emissions by 2050. In addition, the United Nations estimates we will need to mobilise up to $3 trillion per year through to 2050 to achieve net zero.

All investors must consider risk, return and impact. Impact can no longer be considered an externality. Allocating capital to achieve positive impact is the only way we can bring about a net-zero, prosperous, equitable, healthy and safe society.

There are huge opportunities for investors to fund the development of innovative technologies and new companies that will become heavyweights of our sustainable future. But we need to finance the more difficult climate solutions such as grid connectivity in emerging markets, zero-carbon steel and regenerative farming, as well as the low-hanging fruit such as further scaling proven renewables and electric vehicles.

We must also strive to ensure that we are addressing historic inequities caused by our continued dependence on fossil fuels, and work to ensure that future investments address issues of inequality rather than perpetuate disparities. This means we must step up efforts to support developing countries. While these countries represent the fastest-growing sources of emissions globally, they receive far too low a share of climate finance to support their transition away from fossil fuels. To organise and accelerate this transition, new international financial institutions focused on providing climate finance and catalysing private finance are needed urgently.

End Anti-Climate Finance

Too often the discussion around the need for greater climate finance obscures the need to also end the many sources of ’anti-climate finance’, ranging from continued bank and investor financing of fossil fuel expansion to government subsidisation of fossil fuels. Today, fossil fuels receive over $440 billion per year in direct subsidies[3], perpetuating global reliance. The ‘implicit subsidies’ (including the failure to compensate for the extensive harms inflicted on the world by burning fossil fuels) are far larger still. Moreover, the recent invasion of Ukraine by Russia illuminates the destabilising impact of continued dependence – especially by Europe – on petrostates like Russia. And yet, around the world, money from banks, pension funds and other sources of capital continues to flow into new fossil fuel projects. Banks in the West and East alike continue to finance new pipelines and projects.

[3] https://www.iea.org/topics/energy-subsidies

The bottom line is we must cease to finance new fossil fuel assets. The International Energy Association's (IEA) scenarios make it clear that incremental fossil fuel discovery and production is not needed in any part of our energy system to 2050.[4] For those investing in such assets, not only do they pose a climate risk, but they also run the risk of their assets being stranded. For asset owners and asset managers, the engagement approach with financial institutions is clear – do not invest in new carbon-intensive projects. Investors must also continue to focus on challenging banks which continue to finance huge pipelines and pipeline development projects.

Nature

"We are part of nature, not separate from it."[5]

This simple statement is far from reflected across investing practices. We must stop the systematic degradation of critical landscapes by ending deforestation and other destructive practices. Simultaneously, we need to significantly ramp up nature-positive finance to advance an integrated approach to stewardship, combined with the sustainable harvesting of resources we require. We cannot achieve net zero or the sustainable development goals (SDGs) if we fail nature.

Natural climate solutions, including carbon sequestration in soils and forests, can and must play a large role. Carbon markets and other incentives must protect existing carbon sinks and biodiversity hotspots as well as promote additional sequestration and restoration opportunities. However, the current thinking around these mechanisms is underdeveloped. It is crucial that this is accelerated quickly, while putting in place the appropriate guardrails to ensure environmental and human rights integrity. We must be crystal clear, particularly when it comes to offset programmes: we cannot let these measures be an excuse for polluters to continue using the Earth's atmosphere as an open sewer. The entry ticket for the responsible use of offsets must be reducing emissions in line with validated science-based targets (SBTs).

2. ENSURE A JUST TRANSITION

We believe the transition to net zero is inevitable, but ensuring a just transition is not guaranteed. Being green does not inherently mean being fair. It is critical to understand and act on this concept now, as we lay the foundations for the decisive decade ahead. Defining 'success' in the journey to net zero as achieving SBTs alone will prove insufficient, as a net-zero world with increased poverty, social instability, and health and wealth disparity will not be successful at all. Instead, we must now do the hard work of ensuring the path to net zero is a just transition – one which achieves bold environmental goals while balancing equitable social and economic outcomes.

While more people are starting to recognise the connection between a just transition and achieving net zero, there is no common understanding of what the term means. This is a critical issue which must be addressed. We define a just transition to net zero as one which pursues the necessary shift away from GHG emissions across all industries while proactively addressing the associated social and economic impacts, particularly for marginalised communities. Core to a just

[4] https://iea.blob.core.windows.net/assets/deebef5d-0c34-4539-9d0c-10b13d840027/NetZeroby2050-ARoadmapfortheGlobalEnergySector_CORR.pdf

[5] The Economics of Biodiversity: The Dasgupta Review (Feb 2021).

transition is a process in which workers and communities have understanding and agency over the decisions that affect their daily lives, as part of the shift to net zero.

Communities of colour and impoverished populations have paid, and continue to pay, a steep and disproportionate price for the industrialisation causing climate change. The world's most vulnerable are being harmed by a problem they did not create. Climate change is a greater threat to marginalised communities because of where they live, their health, income and limited access to resources. Recovering from the natural disasters which occur with increased force and frequency due to climate disruption is much harder for these communities, as many already suffer from food insecurity, energy poverty, transportation inequity and limited access to healthcare.

In addition, while the populations which disproportionately suffer the negative effects of our high GHG-emitting fossil fuel economy would suffer even more greatly in a world in which temperatures increase more than 1.5C, it is important to recognise that the task of aligning the future with net zero presents significant challenges of its own. The drive towards net zero could result in higher prices for food and energy, impacting the poor and vulnerable fastest and hardest. As a result, crucially, we must expand our thinking and acknowledge that the impact of achieving net zero within the necessary timeframe will not be borne equally or fairly unless properly managed.

As it pertains to the just transition to net zero, investors need to take a sophisticated approach to create system-positive change. This ensures investment decisions are made holistically, with honest conversations about trade-offs. Since a just transition to net zero accounts for communities that have historically been subject to underinvestment, the finance industry must look inwards and take greater strides to incorporate voices from these demographics. A more diverse finance industry might tap into a broader – and otherwise overlooked – range of opportunities that could yield outsized returns.

3. MEASURE, REPORT AND ENGAGE

We need to find ways to measure and reflect the **time value of carbon** in valuation, engagement and investment decisions. This is the concept that carbon reductions today are more valuable than reductions in the future. Companies that are rapidly decarbonising today – rather than waiting for others to move first – are creating a competitive advantage for themselves that will only increase as the prospect of an orderly transition reduces.

We believe climate and inequality risks must be incorporated into every assessment of the soundness of financial institutions, every investment and every lending decision. More consistent data is needed, with clear global standards to ensure disclosures are comparable and can be audited. The private sector has taken climate disclosure a long way on its own, but reporting now needs to be made mandatory by governments.

Aligning portfolios with a net-zero future is essential. Financed emissions analysis is the most common assessment tool today but has major disadvantages, including not taking account of the emissions-reduction trajectory companies are on and therefore disincentivising the financing of asset decarbonisation. Portfolio alignment tools can help, because they use forward-looking climate scenarios to break down the carbon budget into sectors and geographies, and allow investors to differentiate between those companies that are decarbonising and those that are not. These tools still require investment, however, to be used at scale.

As Generation's practice shows, stewardship has a critical role to play. Indeed, it is now a vital investment function. In listed equity, engagement and voting – including voting on director elections – are the tools by which investors can, at scale, encourage companies to decarbonise in line with a 1.5C pathway. Where engagement and voting have failed, shareholder resolutions and the nomination of new directors provide the means to mobilise the broad shareholder base, set new norms and reboot engagement by making investor requirements clear. At many shareholder meetings, management proposals on climate transition plans are offering a new voting opportunity. Across listed and private equity, we are past time where companies can simply be credited for having made progress. Plans must be examined through a rigorous 1.5C lens and opposed by investors if they fall short.

OUR FIRM[6]

Generation is a pure-play sustainable investment manager – it is all we do, and all we will ever do.

The way we operate our firm is a critical indicator of our commitment to generate positive impact. Last October, we held our first ever all-team gathering. After nearly 18 months of mostly working remotely, it was truly wonderful to be together in person. Our critical action item was to reaffirm our mission and core values.

Our equity, diversity and inclusion work is a priority of our Management Committee. There are 35 Partners at the firm and our gender and ethnic background representation data at leadership levels is as follows:

Gender

	Men	Women
Partners	**63%**	**37%**
Leadership committees representatives	**55%**	**45%**

Ethnic background[7]

	White	Mixed / multiple ethnic groups	Asian	Black	Other ethnic group
Partners	**69%**	**6%**	**14%**	**9%**	**3%**
Leadership committees representatives	**80%**	**0%**	**10%**	**10%**	**0%**

Our promotion and remuneration processes are rigorous and meritocratic. There is equal compensation for equal roles. On a UK Government-endorsed statistical basis, Generation still has a gender pay gap. This is due to a large percentage of associate-level colleagues who are women, and because there are fewer senior women investment professionals. We are committed to achieving further progress.

[6] Please also refer to our recent investor letters for updates on our investment strategies.

[7] Consistent with UK Office of National Statistics ethnic group breakdowns

Our workspaces meet the highest environmental impact standards. Our London office is certified BREEAM Excellent, and the 2021 interior fit-out achieved SKA Gold. Our San Francisco office carries a LEED Platinum certification. In addition, we recently installed a state-of-the-art teleconferencing capability. Our aim is to halve our business travel emissions in 2022, versus 2019.

Our Impact Initiatives

In our 2021 Senior Partner Letter, we committed to work with others to achieve five societal objectives by 2025:

1. A global price on carbon;
2. A Just and Inclusive Transition ensuring workers are empowered through receipt of a living wage;
3. All asset managers, asset owners, insurance companies and banks committed to a 2050 or sooner net-zero target with robust portfolio alignment reporting;
4. Deforestation-free supply chains; and
5. Adoption as a best practice for capital allocation frameworks to measure risk, return and impact – which, again, can no longer be deemed an externality.

During 2021, we made important strides on objectives three and five. We reaffirm our commitment to all of the objectives. We expect the three pillars of action for the finance sector and our impact initiatives described below to contribute significantly to this ambition.

Engagement/Collaboration

In 2020, Generation committed to align the investment portfolios we manage on behalf of our clients with net-zero emissions by 2040. Last year at COP26, we disclosed interim targets of 60% science-based target (SBT) coverage across all assets under management by 2025 and 100% SBT coverage by 2030 (as of March 2022, SBT coverage in Generation's Global Equity strategy stood at 25%).

Corporate emissions reduction is built upon carbon disclosure, SBTs and an implementation strategy that breaks the job into manageable chunks. We have seen significant progress in our portfolios since we made our net-zero commitment. Where necessary, in listed equity, we are making clear to companies that it is our practice to align our proxy voting on director elections with our climate-related expectations. In private equity, our practice is to engage companies on their SBT plans at the time of underwriting and commit to annual measurement and reporting.

Our commitment to net zero by 2040 applies equally to our own operational emissions as a firm across Scopes 1, 2 and 3. We are actively working on this under the direction of our Environmental Steering Committee.

At COP26, the Net Zero Asset Managers initiative (NZAM) announced that it had reached 220 signatories, with $57 trillion in assets under management. The broader Glasgow Financial Alliance for Net Zero (GFANZ) reported that it had gained more than 450 signatories, responsible for assets of over $130 trillion[8], across banks, asset owners, asset managers, insurers and financial sector service providers. Over 30 financial institutions, representing $8.7 trillion in assets, including Generation, committed to the goal of eliminating forest-risk agricultural commodity-driven deforestation activities at the companies in their investment portfolios and in their financing activities by 2025.

The Generation Foundation

The Partners of Generation established the Generation Foundation alongside the firm in 2004 and allocate 5% of distributable profits to the Foundation each year. The Foundation is a separate charitable entity that shares Generation's mission to drive a more sustainable economic system. The Foundation executes its mission by conducting deep research to identify the interventions that could catalyse transformative change. Only once it has identified these interventions and outcomes does it seek out organisations to deliver the work, and then collaborates closely with them to design a project or programme. The Foundation's work begins with grant allocation and continues with deep support for its grantees to amplify their impact.

In 2021 we saw the fruits of some of the first grants made under the Foundation's new strategy, now in its second year of execution. For example, the *Legal Framework for Impact* report was published, which aims to overcome barriers preventing mainstream finance from playing its part in the achievement of societal goals like the SDGs and limiting warming to 1.5C. Another highlight was our work with the Social Mobility Foundation, including the launch of the Careers for Good programme, which supports students from low-income backgrounds to access careers in mission-driven organisations.

In addition to strategic grant-making, the Foundation is committed to building on the insights and expertise of Generation colleagues and nurturing our culture of service. That culture is exemplified by the participation of 97% of Generation colleagues in the Foundation's matched giving programme in 2021.

Just Climate

Just Climate is a new business **established by Generation in 2021** whose mission is to work in partnership to limit global temperature rise to 1.5C, by directing and scaling capital towards the most impactful climate solutions and supporting capital markets to incorporate climate and just transition considerations into capital allocation decisions. For Just Climate, climate-led investing is an investment approach that seeks to catalyse timely, positive climate impact at scale, while aiming to deliver appropriate, risk-adjusted returns.

Climate TRACE

Climate TRACE is a non-profit coalition of AI-based tech companies, non-government organisations and universities fusing data streams from 300 existing satellites; 11,100 land-, sea- and air-based sensors and other data sources to directly measure emissions. The Partners of Generation have provided significant funding for Climate TRACE.

Ahead of COP26, Climate TRACE released the first independent, comprehensive inventory of global emissions for every country in the world, all divided into ten economic sectors and 38 subsectors. This country-level data, openly and freely available **online**, demonstrated that

[8] We use the $130 trillion figure while recognising the credibility questions raised and note the figure underscores the significant risk of greenwashing.

existing self-reported emissions data has failed to capture the reality of emissions in many important sectors, including oil and gas production and land use.

The Climate TRACE coalition will continue to accelerate progress towards an era of radical transparency for global emissions this year. By COP27, Climate TRACE will release asset-level emissions data in each sector, providing an inventory of emissions from individual power plants, ships, factories and more. This will be supplemented by other relevant data, including the current ownership of all of the most significant assets.

A FINAL WORD

The road from Glasgow is about urgent action.

The urgency and scale of the climate crisis requires transformational change rather than incremental change. The transition to net zero will be the most significant shift in our lifetimes, indeed possibly in history. However, it will be difficult, front-loaded, uneven and exposed to significant risk.[9] Critically, a just transition is not guaranteed.

There are four reasons the world needs and deserves leadership from the finance sector as we transition to net zero. Firstly, we are part of the problem. In aggregate, we are investing in assets which imply the failure of the Paris Agreement. We are not allocating enough capital to climate solutions or a just transition. We are not properly accounting for the impact of our investments and actions.

Secondly, it matters to our clients. The net-zero transition will be more comprehensive than the industrial revolution and faster than the digital revolution. All of our portfolios and all asset classes will be impacted. In addition, our clients are increasingly making their own net-zero commitments.

Thirdly, resolving the climate crisis will require not only reducing emissions to net zero, but also keeping total cumulative emissions within a defined carbon budget en route to net zero. At its heart, this is fundamentally a capital allocation problem. This is what we do. However, it is also increasingly apparent that innovation in capital allocation will be needed. Investors will be evaluated against three criteria going forward: risk, return and impact.

Lastly, we said we would. The finance sector stepped up at COP26. It delivered commitments aplenty. It is now time to deliver.

Our three pillars of action – Invest; Ensure a Just Transition; and Measure, Report and Engage – show a way forward. We have the fiduciary and moral responsibility to act, and we have the means. The window for action is now.

David Blood, Senior Partner,
on behalf of the Partners and employees of
Generation Investment Management and Just Climate

[9] McKinsey Global Institute, The Net Zero Transition (2022).