



Climate Allocation Compass, a Framework for Real-World Decarbonization (Compass-FRWD)

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About the Columbia Center on Sustainable Investment

The Columbia Center on Sustainable Investment (CCSI), a joint center of Columbia Law School and Columbia Climate School at Columbia University, is a leading applied research center and forum dedicated to the study, practice, and discussion of sustainable international investment. Our mission is to develop and disseminate practical approaches and solutions, as well as to analyze topical policy-oriented issues, in order to maximize the impact of international investment for sustainable development. The Center undertakes its mission through interdisciplinary research, advisory projects, multi-stakeholder dialogue, educational programs, and the development of resources and tools.

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Executive Summary¹

In the context of a significant shortfall in investment required to achieve global climate goals, the purpose of this paper is to discuss how Financial Institutions (FIs), and in particular investors, can help both bridge the investment gap and decarbonize the real economy through a framework of intentional capital allocation. This allocation should be based on capital needs identification, rigorous methods and metrics, and purposeful collaboration across the industry, as well as with key change-makers such as policymakers and multilateral banks.

In particular, the Columbia Center on Sustainable Investment (CCSI) and Man Group have developed the Climate Allocation Compass, a Framework for Real-World Decarbonization (referred to as Compass-FRWD hereafter). It seeks to depart from conventional practices, where there is (1) no incentive to financially support the transition of carbon-intensive sectors to net zero and (2) no framework to set ambitious targets for transition-enabling capital allocation beyond requirements to increase capital flows over time.

Our approach

By contrast, we advocate for a top-down, long-term, iterative approach to strategic investing in decarbonization that aligns with fiduciary duties, integrates decarbonization needs into portfolio construction alongside traditional financial requirements, sets the tone for stakeholders and portfolio companies, and fosters accountability through monitoring, reporting and adapting.

Thus, Compass-FRWD is an asset allocation framework designed to guide strategic capital distribution across multiple portfolios. The Compass-FRWD structure encompasses six steps:

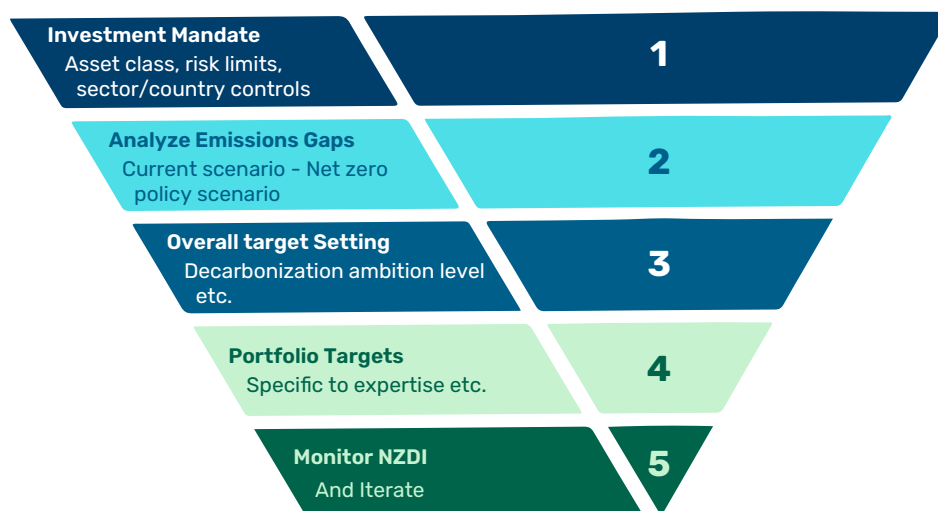
- **Step 1:** To comprehensively understand the sectors and regions covered by the collective investment mandates of all portfolios utilizing this framework.
- **Step 2:** Calculate the emissions gaps of these regions and sectors, by comparing the emissions results from the current policy scenario and the net-zero scenario in Integrated Assessment Models (IAMs).
- **Step 3:** Define optimal percentage targets for capital distribution across the portfolios. The percentage targets for specific sectors or regions are equal to the relative emissions gaps while the percentage targets for climate solutions are their relative Emissions Reduction Potential (ERP) as indicated by a global sectoral pathway.
- **Step 4:** Translate these overarching targets into portfolio-specific targets, considering that different portfolios have their own contexts, including asset class, investment focus, and mandates.

¹. All data as of July 2024, unless noted otherwise.

- **Step 5:** Establish regular two-way communication between the overarching target and the different portfolios. With this two-way communication, capital flows can be tracked at the overarching level through a “Net Zero Deviation Index” (NZDI), which is the difference between how capital allocation is distributed and how it should be according to the initial targets set in the third step. The objective is to progressively reduce the NZDI with each deployment cycle. The ultimate aim is to achieve an optimal distribution of capital allocation across regions and sectors, assuming that if all investors follow this compass, the gap to net-zero emissions will close.
- **Step 6:** Given the various challenges in closing this gap, the final step is to implement an iterative portfolio construction strategy designed to mitigate investment constraints. Setting the strategy at the overarching level is advantageous, as one can leverage the strength of a multi-asset class response and define areas of engagement and collaboration across FIs and stakeholders.

Integral to Compass-FRWD is the development of an asset and entity screening process to ensure that any asset acquired aligns with a net-zero trajectory. It involves ensuring investments are aligned with both officially defined climate-aligned activities (e.g. as per taxonomies) and with robust net-zero transition plans at the entity level. When opportunities are comparable, asset selections should maximize the carbon impact ratio.²

Figure 1: Visualizing Compass-FRWD, step by step



Schematic illustration.

Enduring challenges

Significant challenges remain in targeting emissions gaps, ensuring additionality, and realizing the full intention of Compass-FRWD. While fixed income investments, particularly Green, Social and Sustainable (GSS) bonds, hold the highest potential for impact within the realm of climate finance (due to their signaling effect, their critical role in influencing firms’ cost of capital, providing ongoing financing opportunities and attracting a sustainably-oriented investor base), they are a nascent market. As the GSS market evolves, it is important to balance the need to create entry points for new issuers and to promote harmonized credible and robust standards.

². The ratio of avoided emissions to induced emissions.

Attracting international investors to Emerging Markets and Developing Economies (EMDEs) is hampered by factors such as a lack of investment-grade credit ratings, higher capital costs, currency risks, and a small investible project pipeline. Additionally, a lack of high-quality, reliable, and comparable data on corporate transition plans hampers the ability of financial institutions to allocate capital effectively and prevent greenwashing. Even with rigorous qualitative analyses and genuine efforts to support sustainable practices, the absence of robust data can lead to perceptions of insincerity or misrepresentation. This fear of unintended greenwashing may constrain the flow of capital when investors remain cautious about potential reputational risks and the integrity of their environmental claims. Engagement with portfolio companies is often insufficient despite commitments to net-zero alliances, and the focus on reducing portfolio emissions, rather than achieving real-world decarbonization, is still prevalent.

Addressing these issues is essential to reducing emissions on a global scale and ensuring effective capital shifts toward decarbonizing the real economy. Adopting a multi-asset class strategy helps accommodate the diverse Technology Readiness Levels (TRLs) required for decarbonization: Lower TRLs are riskier than higher TRLs and the spectrum of risks along the TRL scale can be matched with suitable asset classes according to their risk profile. A multi-asset class framework also ensures a coherent cross-asset strategy. Additionally, investors can leverage technology, such as generative artificial intelligence, to sift through vast amounts of data to identify companies and technologies crucial for decarbonization, enabling them to construct diversified portfolios aligned with the global transition to a low-carbon economy.

A collaborative effort

Collaboration with policymakers, across the industry, and with the Multilateral Development Banks (MDBs) is vital for effective capital deployment and addressing bottlenecks in portfolio allocation. Engaging with policymakers is critical to fostering an enabling environment for sustainable finance initiatives and non-state actors' effective climate action, while partnerships with underwriters and asset managers can improve the legal and sustainable quality of issuances. Collaborative approaches between asset owners and managers can align investment preferences with decarbonization commitments, developing innovative financial instruments to de-risk investments in climate solutions. Furthermore, engaging with portfolio companies to refine their transition strategies ensures alignment with decarbonization goals, while partnerships with MDBs can optimize the development of bankable projects, investible issuances and unlock private finance opportunities in EMDEs.

Through these collaborative efforts and a comprehensive decarbonization framework aimed at allocating capital where it is most needed, we can make significant strides in combating climate change and achieving a sustainable future.