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Defining and aligning climate investment intentions

Decarbonising your strategy may provide a path to net zero, with the added benefit of clearly addressing stakeholder concerns

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Charities, endowments and foundations are highly likely to be interested in ensuring their organisations' investments are aligned with climate-positive goals. Stakeholders, as well, may be voicing concerns about how and where funds are invested, and keen to see that investments are being directed to address environmental issues.

Decarbonising your index strategy may offer the ability to both clearly articulate a net-zero pathway and define its progress year-on-year. This could provide funders and beneficiaries alike with the assurance that your organisation's investments are working coherently toward the avoidance of the worst-case scenarios for global warming.

Reaching net-zero emissions by 2050 is considered the safest way to limit global temperature rises to 1.5°C above pre-industrial levels, avoiding some of the worst impacts of climate change[1]. As a result, many investors are looking to reduce the exposure to carbon emissions within their index strategies. This process requires a decarbonisation pathway that could align to a 1.5°C scenario.

There are different avenues to delivering a decarbonised index strategy with net-zero ambitions. We focus on the exclusion and capital allocation methods, as well as a combination of the two.

[1] Intergovernmental Panel on Climate Change: Special Report on Global Warming of 1.5°C (2018)

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The role of exclusions

The exclusion approach, also known as negative screening, has been used to avoid having specific stocks or industries in an index. The most prominent exclusions have tended to cover companies involved in tobacco, alcohol, gambling, fossil fuels and controversial weapons.

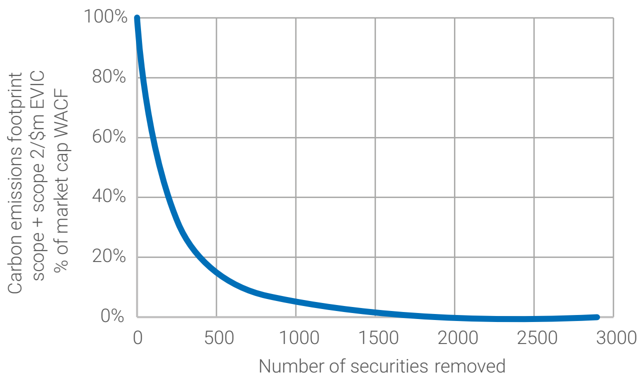
Different exclusions can resonate with different types of investors and across different regions. Some prefer this approach as it is transparent, easy to communicate and offers peace of mind if an investor's ultimate objective is to remove exposure to specific securities and sectors.

But aggressive exclusions may significantly alter the portfolio's profile. As the level of exclusions increases, the adjusted index often strays from its parent benchmark, and the index may no longer deliver a market-like, risk-return profile. This means that there is potential for the index to incur unintended active risk as compared to its benchmark.

Global market capitalisation indices allow us to make two observations: first, a stock can have a high-carbon intensity and contribute a sizable amount of carbon to the portfolio; second, a stock may have a low intensity but if it is heavily weighted in the benchmark it may still contribute sizeably to the overall emissions of the index.

Figure 1 shows that by removing just 30 securities (out of 2,827 in a global stock index) it is possible to achieve a 37% emission reduction in a global stock index from the Q1 2022 total emissions intensity level and a 50% emissions reduction from 2019 portfolio levels. This reduction can be achieved, typically, with a tracking error[2] of less than 0.50% for a globally diversified strategy.

Figure 1. Carbon intensity reduction and number of removed securities in a global stock index



Source: LGIM, ISS, Refinitiv, MSCI, Solactive as at 29 April 2022.

There is a role for exclusions in a net-zero approach, for example, to remove companies that are highly misaligned and have little likelihood of being willing or able to transition. Relying solely on an exclusionary approach to achieve net-zero portfolios, however, could be problematic. It may not always address the real-world needs for decarbonisation and may remove the possibility of the asset owner engaging with investee companies to change their behaviour and address specific sustainability risks.

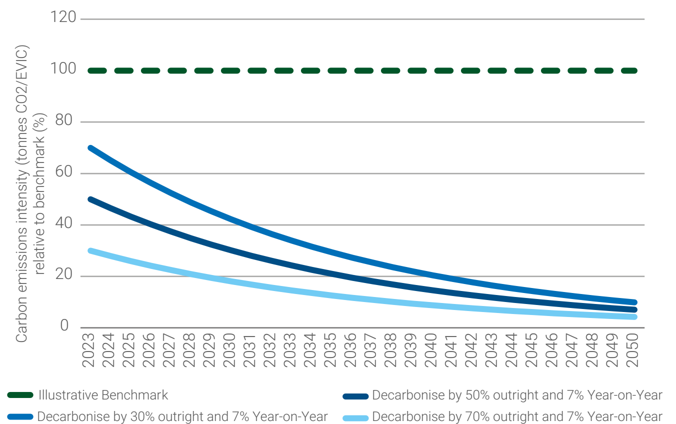
For these types of emitters, an engagement approach may be more fruitful in achieving carbon emissions reductions. At LGIM, we have a long history of climate-focused corporate engagement activities undertaken by our Investment Stewardship team, which focuses on holding companies to account for the pledges they make and actions they take.

Reallocation of capital

A common decarbonisation pathway, based on recommendations from the Intergovernmental Panel on Climate Change (IPCC) and the EU Paris-aligned Benchmarks (PAB), is to reduce carbon emissions intensity by a fixed percentage relative to a parent benchmark. The index portfolio would then continue to be decarbonised by additional percentage points each year.

Figure 2 shows different decarbonisation objectives that investors may choose from to embark on a net-zero pathway. The middle line shows a pathway which reduces an index portfolio's carbon intensity by 50% by 2030 before continuing with a carbon reduction trajectory of 7% year-on-year, with a goal of reaching net-zero by 2050.

Figure 2. Decarbonisation of net-zero pathways



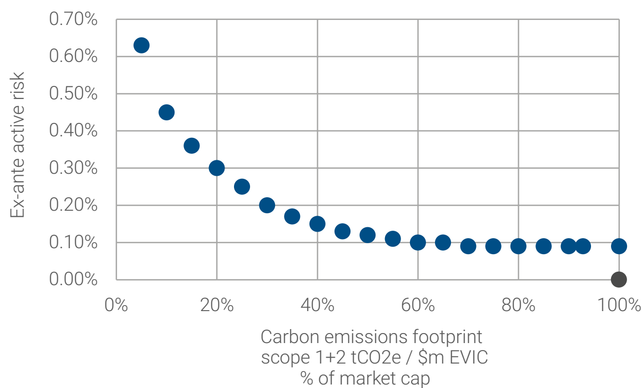
Note: For illustrative purposes only. The illustrated baseline assumes no changes to the level of carbon emissions in aggregate. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass. The future emissions intensity of the underlying benchmark is unknown (dashed line).

[2] Tracking error is a measure of financial performance that determines the difference between the return fluctuations of an investment portfolio and the return fluctuations of a chosen benchmark.

The aim here is to reallocate and adjust the exposure from stocks with high-carbon intensity to those that are less carbon-intensive, subject to various investment constraints which may include security or sector deviations from the parent benchmark. As a result, a decarbonised index may have different constituents and/or a different number of holdings than its parent benchmark.

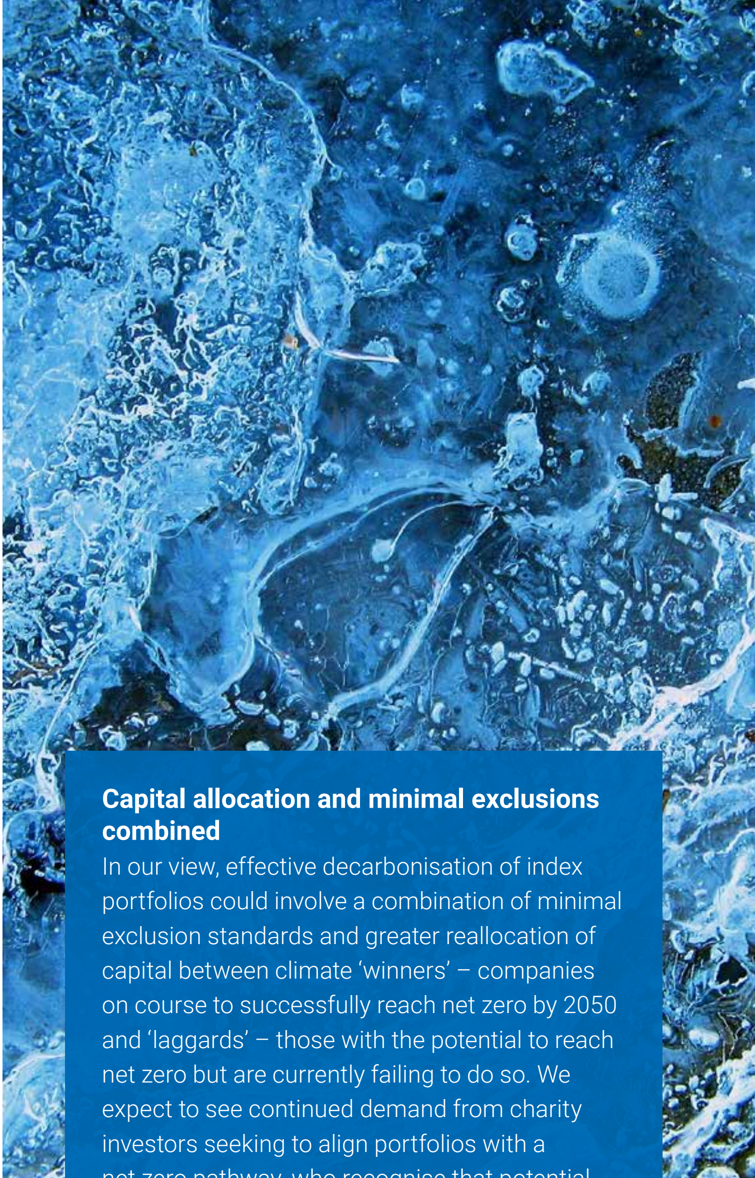
Below, we provide an example of creating a holistic index solution for transitioning to a 1.5°C environment to aim to reduce potential climate risks. The starting stock universe is based on market capitalisation for developed and emerging markets. We can illustrate the tracking error implications for various degrees of decarbonisation rates subject to a range of investment constraints.

Figure 3. Decarbonisation rates versus tracking error



Source: LGIM, Solactive, MSCI, ISS, Refinitiv. Carbon footprint measured as tCO2e Scope 1 + Scope 2 /$m EVIC. Constraints on security +/-3%, sector +/- 3% and regional neutral. Minimal exclusions applied: thermal coal, UNGC violators, which represent 1.2% of the total weight of a global market universe (developed and emerging markets). Calculations based on: Qontigo. Portfolio Holdings and Risk model as at 29/04/2022. Broad market capitalisation global equity Index is based on MSCI ACWI, Solactive.

Figure 3 shows that it could be possible to decarbonise a global index with a low tracking error; our analysis indicates that a 50% carbon intensity reduction can be achieved with around 15 basis points of tracking error. However, the tracking error rises sharply when the decarbonisation increases beyond 50%. The results may vary for specific regions and more concentrated indices.



Capital allocation and minimal exclusions combined

In our view, effective decarbonisation of index portfolios could involve a combination of minimal exclusion standards and greater reallocation of capital between climate 'winners' – companies on course to successfully reach net zero by 2050 and 'laggards' – those with the potential to reach net zero but are currently failing to do so. We expect to see continued demand from charity investors seeking to align portfolios with a net-zero pathway, who recognise that potential financial and climate risks are different across different regions and industry sectors.

We also expect that increasing investor attention may be paid to broader climate themes such as biodiversity, as well as social and governance factors, all of which may complement a net-zero index strategy.

Charities interested in learning more about how they may incorporate an index decarbonisation strategy into their portfolio should contact their LGIM representative.

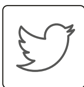
For a more in-depth look at decarbonisation of index strategies, our research paper is available **here**.

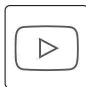
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass. The above information does not constitute a recommendation to buy or sell any security.

LGIM's decarbonisation of index strategies:
www.lgim.com/uk/en/insights/our-thinking/esg-and-long-term-themes/decarbonising-index-strategies/

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative





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