ASSET MANAGEMENT

The Opportunities in Net Zero for Passive Asset Owners

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The author would like to thank Gregga Baxter and Jeff Woolsey for their contributions

The Opportunities

Investing in sustainable indices is an opportunity for Asset Owners to align with sustainable principles without sacrificing return, or taking on more exposure to risk.

Sustainable indices are usually based on a parent index, for example MSCI World is a parent index for a number of different ESG indexes, such as MSCI World ESG Screened Index and MSCI World ESG Universal Index. The MSCI ESG and Climate indices are designed to support investors seeking to align their benchmarks with sustainable objectives, split between screening indices (MSCI World ESG Screen Index), integration indexes (MSCI World ESG Universal Index), and target indexes (MSCI World Paris climate Aligned Index).

Most sustainable indices have historically shown that they are resistant to market downturns, whilst not compromising on returns. Asset Owners do not need to stray from principles of sustainable investing, even during times of a challenging environment.

When comparing sustainable indices against their parent benchmark over the past 10 years, we found that performance was imperceptibly different when compared to that of the parent benchmark, yet the daily variance was relatively small.

Chart 1

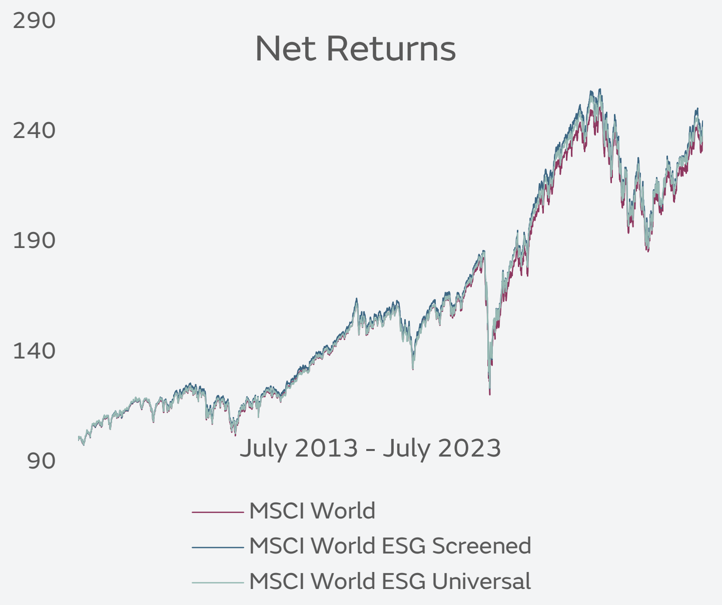
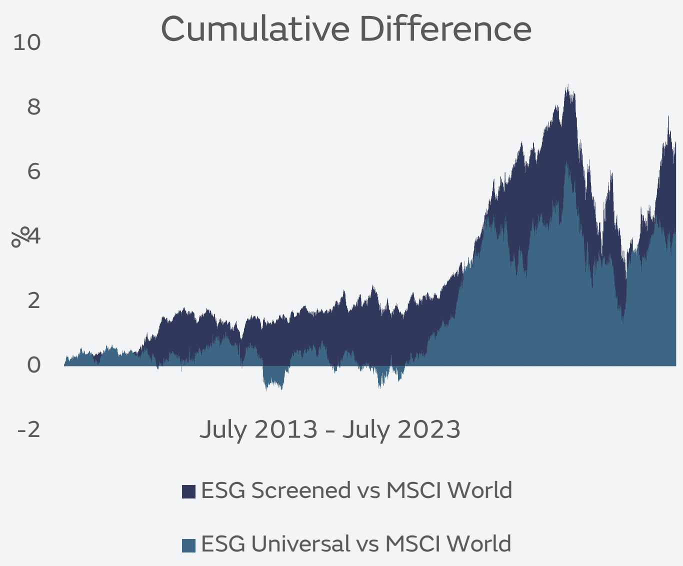
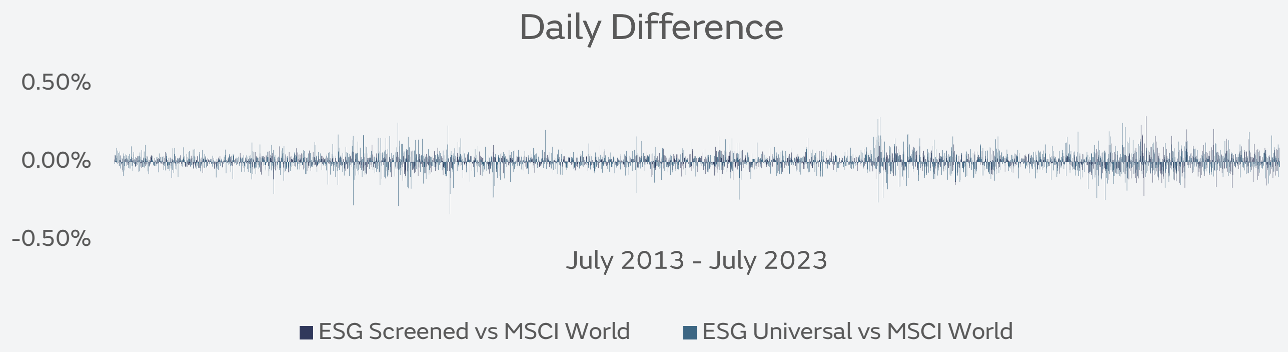


Chart 2



Source: Bloomberg (MSCI World Index, MSCI World ESG Screened, MSCI World ESG Universal)

Chart 3



Source: Bloomberg (MSCI World Index, MSCI World ESG Screened, MSCI World ESG Universal)

As most sustainable indices are based on their parent index, the characteristics, such as diversity of country weights remains similar, with some small deviations, as those in the parent index.

Chart 4

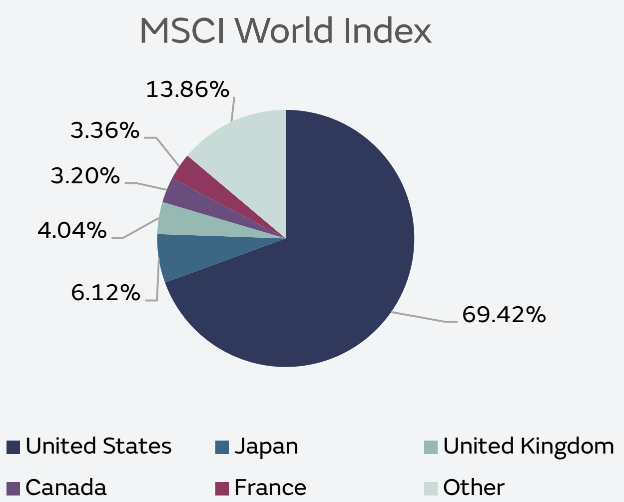


Chart 5

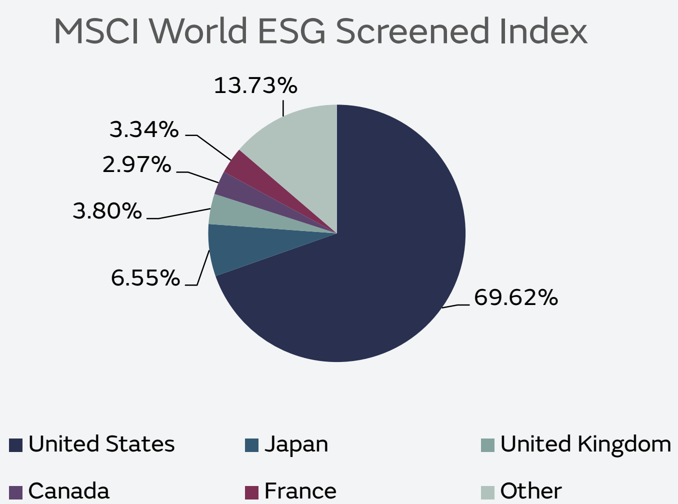
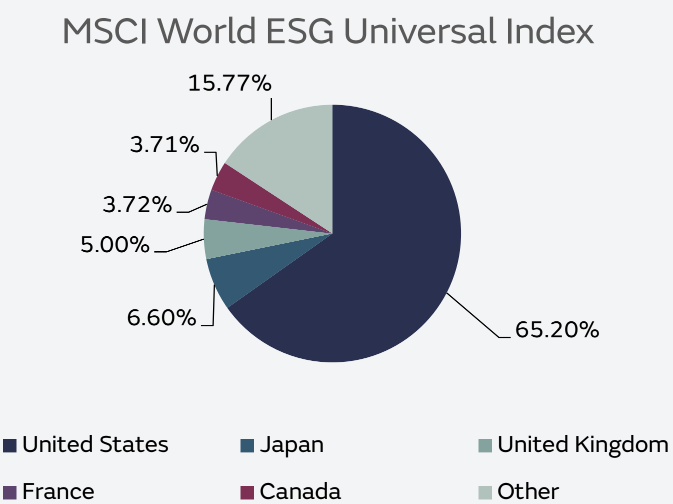


Chart 6



Source: Bloomberg (MSCI World Index, MSCI World ESG Screened, MSCI World ESG Universal)

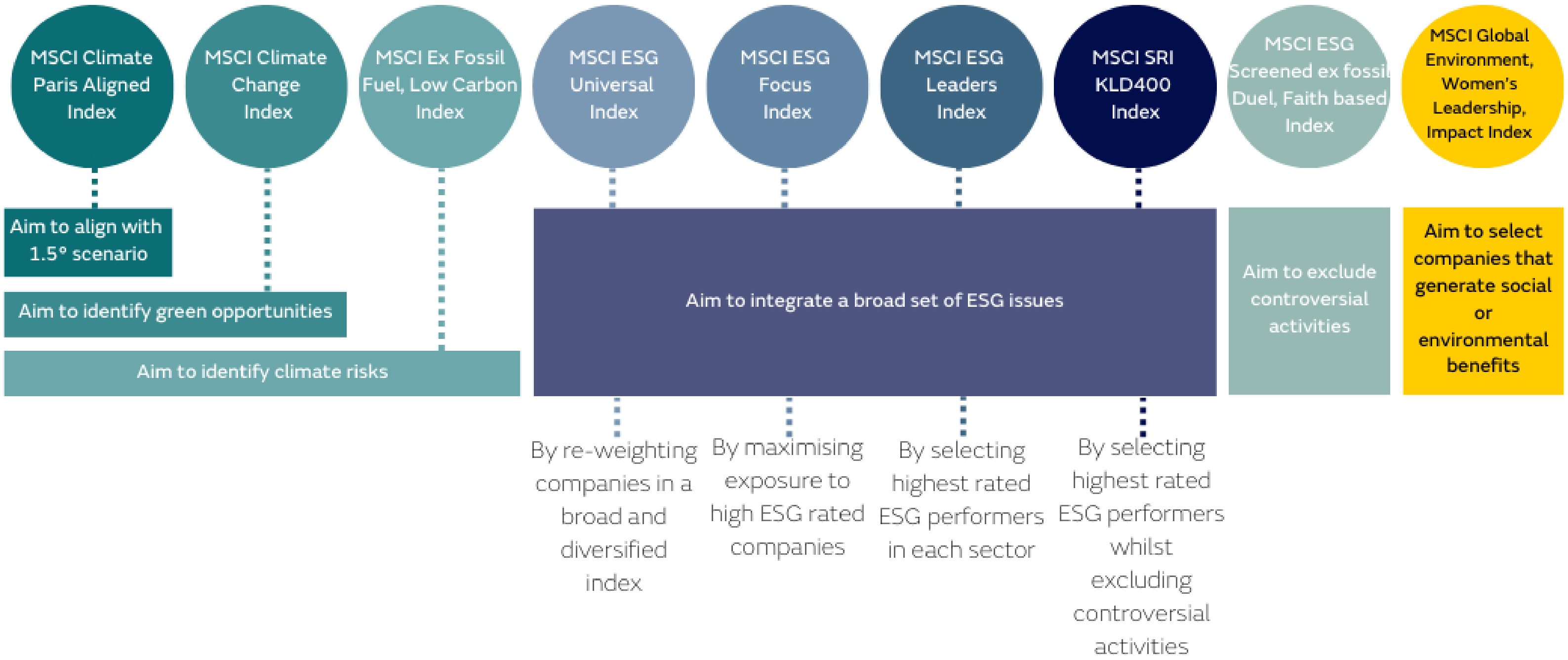
Investing in a sustainability labelled index does not significantly alter the characteristics of the portfolio (Charts 4-6). Investing in a sustainable index that either screens or integrates ESG data does not mean asset owners have to sacrifice returns or increase their risk profile, given the risk, or volatility, is the same compared to the parent benchmark, and the sustainable indices have shown to outperform the parent benchmark over a mid-long term time horizon.

Credible Action through Passive Investments

In previous years, it has been largely believed that the way to shift investments to those that incorporate environmental, social and governance factors was to put more money into actively-managed sustainability-aligned funds. Whilst active stock selection is a valid approach for higher returns, a passive approach is an opportunity for asset owners to align with sustainability principles without sacrificing return or increasing their exposure to risk.

With that being said, more and more asset owners have begun allocating to sustainable-labelled indices, with the amount of sustainable-focused investment tracking indexes rising more recently. A recent report from the Net Zero Asset Owner Alliance conceded that "benchmarks are efficient and practical tools for integrating decarbonisation objectives into the investment process and for supporting net-zero portfolio alignment"[1]

The MSCI ESG and Climate indexes are designed to support investors seeking to align their benchmarks with sustainable objectives, split between screening indexes, integration indexes, and target indexes:



Source: https://www.msci.com/our-solutions/indexes/esg-indexes

[1] https://www.unepfi.org/wordpress/wp-content/uploads/2022/11/NZAOA_Development-and-Uptake-of-Net-Zero-Aligned-Benchmarks.pdf

At the screening end, passive asset owners can look to the MSCI World ESG Screened Index to use exclusionary screens to align portfolios with their social values and global norms, and avoid risks such as stranded assets. The index also targets at least a 30% reduction in carbon emission intensity relative to the underlying parent index.

In the middle are the integration indices, which represent diversified strategies but integrate ESG analysis into broad-based indices. The MSCI World ESG Universal Index is an example of this, enhancing exposure to sustainability by measuring a company's management of financially relevant ESG risks and opportunities, which can include a company's greenhouse gas emissions if they pose significant financial risks. We believe that Asset Owners who switch to this index would be overweighting their portfolio with those companies with better governance controls in place. This in itself could create impact, by potentially incentivising companies with lower ESG ratings to take action to improve ratings in order to benefit from investor over-allocations.

There is also an opportunity for asset owners to align to specific themes, and using an index is a good way to do this, such as tracking the MSCI World Climate Paris Aligned Index or MSCI World Climate Change Index. However, the thematic indices do have a substantive cumulative difference, and much bigger daily difference than the screening or integration indices analysed in this article. Net returns are higher than the benchmark, however this is accompanied by higher risk, and therefore is a different investment decision than switching to an ESG screening or integration index.

Chart 7

Chart 8

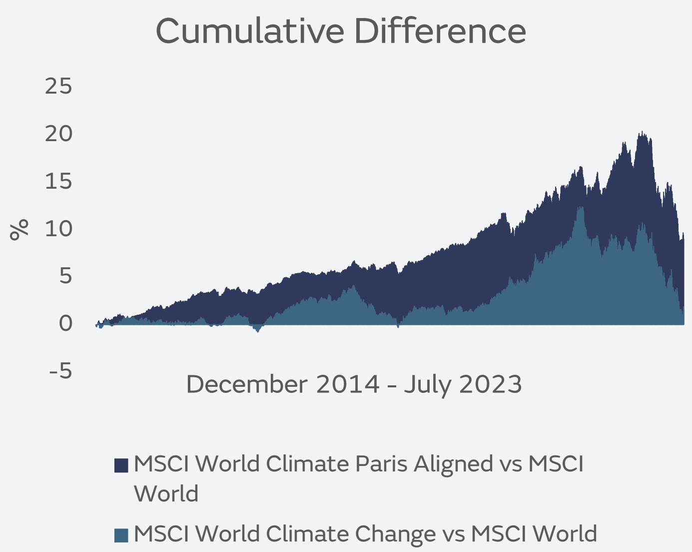
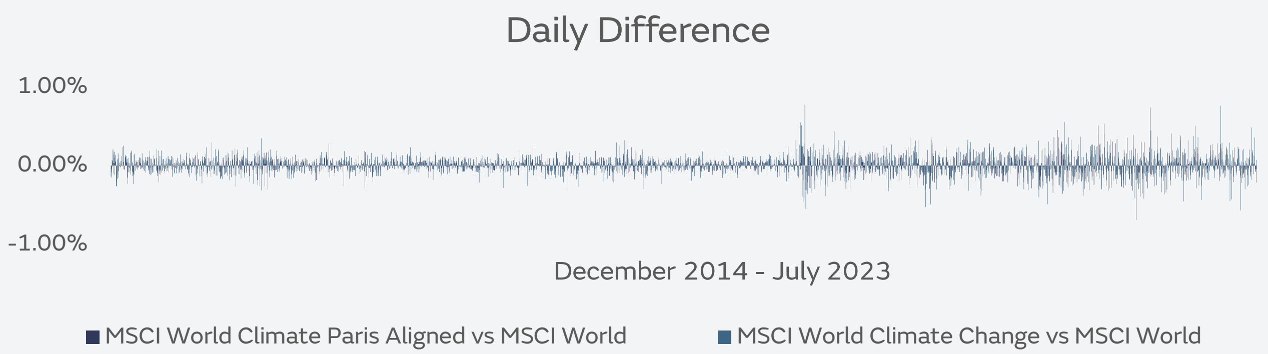


Chart 9



Source: Bloomberg (MSCI World Climate Paris Aligned Index, MSCI World Climate Change Index)

Asset Managers of passive segregated mandates are mostly led by their clients so the ultimate decision will lie with the asset owners. Whilst there may be a variety of reasons that asset owners may not have an active allocation, there is still opportunity for asset owners to have an impact, mainly by instructing their managers to track an index that is screening or integrating ESG data.

Asset Owners could also choose to instruct their managers to engage with investee companies on specific topics, and target those companies that they believe should be taking more action, for example reporting of emissions. While passive managers typically do not engage, we think that as near-permanent holders of a company's stock, larger passive managers, who are likely to have scale and large holdings, have the power to engage positively with laggards or other investee companies. Smaller managers may not have the scale or large holdings, yet asset owners can still support engagement efforts by tracking an ESG index. Once a company is excluded, the manager has no power, and therefore we believe divestment is not the best way to have an impact and lead change.

Bigger Picture Impact

One initiative that we believe could drive real change would be for asset owners to engage directly with benchmark providers around sustainability-focused criteria for companies to be included in benchmarks. Benchmark providers could set specific minimum ESG criteria to allow companies to be included in a benchmark, or alternatively to decide the weighting applied.

A reduced weighting would ultimately mean that investors would hold less shares in the benchmark companies, in turn driving the share price down, and ultimately potentially incentivising the company, as well as the main shareholders, to take action to improve ESG policies at the company.

Why Net Zero?

The Intergovernmental Panel on Climate Change (IPCC) and the Bank of England, as well as many other industry bodies, have identified that climate change will have significant physical and economic impacts.

Emissions released by human activity are already having a disastrous impact on our planet, propelling us further into an irreversible climate crisis, with evidence showing that our planet has already been warming: 2022 was the sixth-warmest year on record[2], and the IPCC's Sixth Assessment report, published in 2021, found that human emissions of heat-trappiing gases have already warmed the climate by nearly 1.2 degrees Celsius since pre-industrial times[3].

We are already experiencing the physical consequencs of incremental warming with loss of polar ice, rising sea levels, acidification of the oceans and erratic weather patterns, such as heatwaves, floods, severe storms and increased wild fires. A continuation of a rise in global temperatures could render parts of the planet uninhabitable.

[2] https://www.climate.gov/news-features/understanding-climate/climate-change-global-temperature#:~:text=The%202022%20surface%20tem-perature%20was,period%20(1880%2D1900).
[3] https://climate.nasa.gov/effects/

“The effects of human-caused global warming are happening now, are irreversible for people alive today, and will worsen as long as humans add greenhouse gases to the atmosphere” – NASA

Some sectors, such as insurance, have already seen financial implications due to the physical changes of climate change, with overall losses from world-wide natural catastrophes totaling $150 billion in 2019[4].

Climate change will also affect many asset types and sectors, impacting portfolio returns and asset valuations. We believe that the asset allocation process for asset owners will need to change in order for asset owners to avoid climate-related risks and realise the opportunities. How a corporation responds to climate issues may affect their valuation, especially for certain sectors, such as the energy sector.

Climate risk is ultimately a financial risk, and therefore asset owners should take action to respond to climate risk across their portfolios. In order to respond to climate risk, Asset Managers could implement decarbonisation goals and Net Zero goals, based on Science-Based Targets, and alignment with asset owners is the key to doing so successfully.

In 2015, 196 Parties at the UN Climate Change Conference (COP21) adopted the Paris Agreement, which has an overarching goal to hold the increase in the global average temperature to well below 2 degrees above pre-industrial levels, as well as pursuing efforts to limit the temperature increase 1.5 degrees above pre-industrial levels. Carbon reduction is one climate goal that is key to reducing global warming, and reaching Net Zero.

Whilst many companies have committed to developing Science-Based Targets, 44% of these companies are still yet to do so[5]. Setting Science-Based Targets could be done as part of the development of a credible transition plan, which are a vital tool for organisations to show their commitment to achieving a 1.5 degree pathway, as well as indicating that its business model will remain relevant, and profitable in a zero carbon economy. Not only are transition plans vital for businesses, they will also be intrinsic in effecting action to achieve a sustainable economy, and ultimately a Net Zero world.

Transition plans are not currently mandatory, however many countries are working on developing mandatory standards, for example, in the UK, Britain’s Transition Plan Taskforce (TPT) is developing mandatory standards for listed and financial firms.

Channeling capital towards Net Zero investments can drive real-world impact on climate change, which is why asset owners are critical to achieving Net Zero. Our analysis shows that asset owners can transition to a sustainable index without having to sacrifice returns or increase exposure to risk, which is even more important in today’s evolving and ever-challenging world. At GIB Asset Management, we believe today’s challenges are tomorrow’s opportunities. Investing in a Net Zero future is not only key to tackling the climate crisis, but can also unlock truly sustainable growth, as well as reducing the financial risk caused by extreme weather damage, as well as other impacts of climate change, leaving a healthy planet for investors to spend their returns in.

[4] https://www.unpri.org/download?ac=10843
[5] https://sciencebasedtargets.org/target-dashboard

Call to Action for Asset Owners

The main way asset owners can integrate ESG into their passive investments is by tracking ESG-labelled indexes, of which there are many focuses on different ESG factors, or overall approaches. Investing in an ESG-labelled index does not necessarily mean a tradeoff for investors, meaning that investing in a sustainable-labelled index does not overly change the characteristics of an index portfolio compared to the parent benchmark. Performance or returns are also not overly impacted, based on our analysis, and in some cases returns can even be greater than the parent index, with sustainable strategies proving to be more resilient than their peers in times of volatility, meaning that there may be less risk to Asset Owners.

Asset Owners also have the opportunity to drive real change by engaging with index providers around enhanced ESG criteria for investee companies, encouraging them to take action on sustainable matters, such as waste or carbon footprint, to ensure their company remains listed within the index.

Asset owners can also encourage their Asset Managers to engage with investee companies, either on specific topics, or with certain companies such as laggards within their chosen index. We believe that engagement is important as it can drive better outcomes. As our investee companies succeed, so do our clients.

Whilst Net Zero presents a global challenge, it also offers huge opportunity, especially to companies taking the lead in the race to Net Zero. These companies are not only expected to outperform their peers over the long-term, but also be more resilient against their peers during market turmoil. This, in turn, reflects into opportunities for Asset Owners, not only to generate superior investment performance through the integration of sustainability into investment decision-making, but also for Asset Owners to assist in scaling capital in support of sustainable development creating personal value, meaning investors can continue to enjoy returns in a better world.