

Low Carbon Indices: A low cost first step for Net Zero 2050 alignment?

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Net Zero 2050 Alignment Now a Key Consideration

The UK has recently declared its latest update to its Nationally Determined Contribution (“NDC”) of cutting carbon emissions by at least 68% of 1990 carbon emissions by 2030¹. Several pension funds and insurers have declared commitments to align with Net Zero 2050 in recent months. This alongside sign-posting from the regulator with the recently released road-path to mandatory climate-related disclosures² (or ‘TCFDs’), amongst other recent regulatory changes, means that ESG and climate risk have been rapidly increasing in importance as a consideration for trustees.

For most pension scheme members, 2050 is certainly within their investment horizon, and so from a risk perspective climate change risk is clearly likely to have a financially material impact on their outcomes. There are many ways to view and address this topic, ranging from a narrow consideration on climate transition risk management, to a wider perspective of contributing to addressing systemic economic and societal risk, to ensure that members retire into a world worth living in. Those with active mandates are likely to be more able and inclined to engage in a stewardship approach, often cited as preferable to divestment. However, those with more passive mandates potentially may be more restricted.

Given VFM Considerations, Are Low Carbon Tilts The First Step?

Given the recent industry focus on value-for-money, cost is likely to be a significant limiting factor on what can be done in practice. With there being many existing demands on the 75bp charge cap, additional efforts to align with Net Zero 2050 could understandably feel like a challenge.

For those with more passive investment strategies, “low carbon” equity indices could be a cost-effective way to make a start. Low carbon equity indices use rules-based methodologies and data to identify potential risks from the transition to a low-carbon economy (through measures such as reported carbon emissions) in constituent exposures. They apply weightings to constituents to underweight negative risks and overweight positive risks, in relation to an existing established equity index benchmark. Given the approach of modifying weightings, they are also often referred to as “low carbon tilts”. The approach is objective and rules-based, but reliant on the quality of backward looking reporting data.

A key advantage is that it is a simple approach that is also straightforward to access, particularly given that they are now available to access via exchange-traded funds at not too great a price differential. In many cases, exchange-traded funds can be a more cost-effective way to access passive equity indices, and savings generated from switching to this vehicle could enable more spend on risk management needs, such as climate risk (or climate transition risk).

There are a range of options from the major index providers, which have devised indexing strategies that incorporate a significant reduction in exposure to “carbon-intensive” companies – and thus reduce exposure to climate transition risk. A few examples are provided in the following table.

Equity sector	Traditional benchmark	Low Carbon benchmark	Reduction in carbon emissions
Global equity	MSCI World	MSCI World Low Carbon Leader	Methodology targets 50% reduction ³
		MSCI World Low Carbon Target	Max. reduction for a tracking error of 0.3%
UK equity	FTSE	FTSE UK Low Carbon Select	Methodology targets 50% reduction ⁴
US equity	S&P 500	S&P 500 ESG	Indirectly incorporated as part of the S&P DJI ESG scoring framework ⁵

For each of these indices, there are exchange-traded funds available. We provide a comparison of fees between the low-carbon and traditional benchmarks, from a survey of the market, in the following table.

¹ <https://www.bbc.co.uk/news/science-environment-55179008>

² https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf

³ <https://www.msci.com/low-carbon-indexes>

⁴ https://research.ftserussell.com/products/downloads/FTSE_ESG_Low_Carbon_Select_Index_Ground_Rules.pdf

⁵ <https://www.spglobal.com/media/documents/the-sp-500-esg-index-integrating-esg-values-into-the-core.pdf>; <https://www.spglobal.com/spdji/en/documents/additional-material/faq-spdji-esg-scores.pdf>

Index	Number of Providers	Lowest Fund Fee	Fee Difference
MSCI World	8	0.12%	
MSCI World Low Carbon Leader	1	0.20%	+0.08%
MSCI World Low Carbon Target	2	0.20%	+0.08%
FTSE All Share	2	0.18%	
FTSE UK Low Carbon Select	1	0.12%	-0.06%
S&P 500	8	0.05%	
S&P 500 ESG	2	0.08%	+0.03%

Data source: Bloomberg; www.justeff.com

Fee differentials are a few basis points, with in one case the low-carbon version being cheaper. In comparison to more direct approaches to sustainable investment, such as through renewable energy infrastructure investment trusts, this level of fee differential looks more attractive.

Risk Return Characteristics

As well as cost, what about the impact on investment performance? Historically, traditional views have considered ESG to lead to added expense, and so imply lower returns. Also, another common view is that the reduction in exposure to specific sectors means lower diversification, and so potentially higher investment risk, for example from the volatility of fund returns. In both cases, 2020 has proved the opposite, when looking at “low-carbon tilts”.

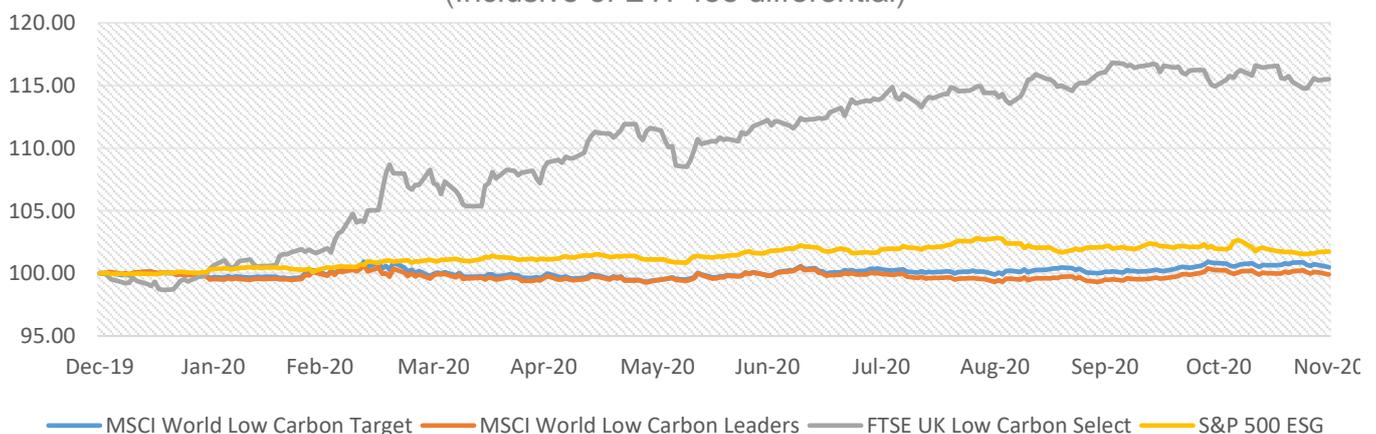
Return differentials, where materially different, have been positive, even allowing for the fee differential. The graph below shows the return of a strategy that goes short the traditional benchmark and long the corresponding low-carbon benchmark, with the fee difference (from previous table) also applied.

Risk differentials, where materially different, have also been lower risk for low-carbon. The graph below shows the difference in common risk measure, 1-year realised volatility, between traditional and low-carbon benchmark. Year-to-date results are dominated by the market volatility in Q1, where low-carbon indices in general experienced lower falls.

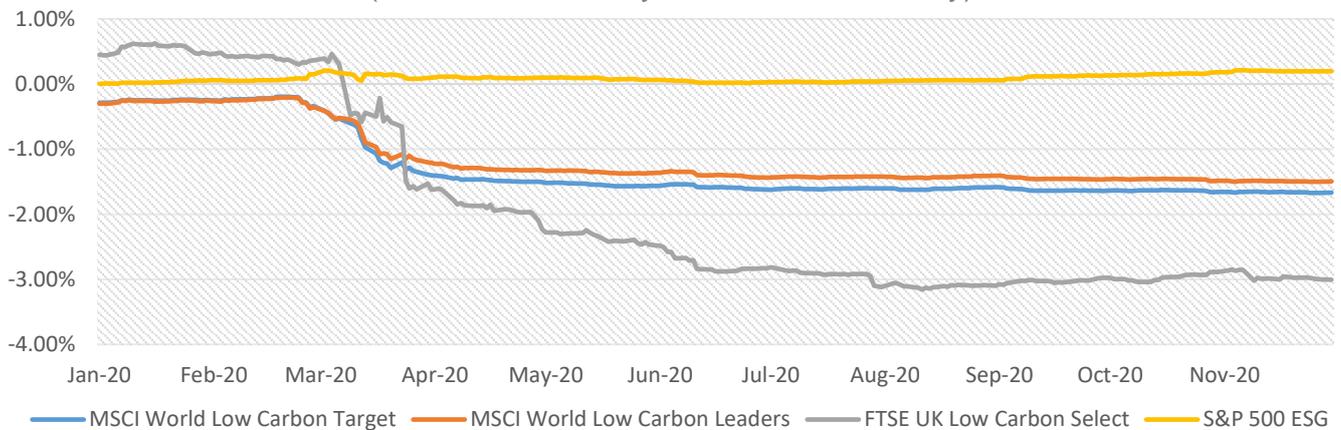
The key variation is with the UK index, with the traditional FTSE benchmark having a large allocation to oil companies, and so reduced exposure to a falling/volatile oil price has been beneficial.

However, we should note that this analysis is a short-term view, pension scheme members and their trustees have long-term horizons, and risk/return differentials can clearly change over the period considered. In a post-pandemic world, where many governments and corporations are planning for a journey of decarbonisation, the potential investment opportunities for return and potential risk from exposures not aligned with these pathways, give credence to favourable risk/return differentials in the longer term too.

2020 Year-to-Date Relative Returns
(Long Low Carbon Benchmark + Short Traditional Benchmark)
(Inclusive of ETF fee differential)



2020 Year-to-Date Relative Risk
 (Low Carbon Benchmark Risk - Traditional Benchmark Risk)
 (Risk Measure = 1-year Realised Volatility)



Data source: Bloomberg

Summary

Low carbon indices are a potentially useful tool to reduce carbon exposure and are increasingly becoming accessible at reasonable cost through exchange-traded funds. The genuine impact they have on carbon emissions is reliant on the quality of underlying data supporting the index construction. However, such approaches and disclosures are coming under ever greater scrutiny, in particular as TCFD's are becoming more mainstream.

Their performance this year has demonstrated that they can be both a useful tool to significantly reduce carbon emissions/footprint from a passive equity portfolio, as well as having favourable returns net of cost, and reduced risk.

Past performance should not be relied on as an indicator for the future – particularly given a number of reasons indicating a post-pandemic regime change. But hopefully these results show that value-for-money considerations are not necessarily a hindrance in taking a first step to aligning with Net Zero 2050.

In our next article, we plan to consider how well these indices align with wider fund risk management approaches.

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