How ETFs can help to achieve net zero

There is an urgent need to accelerate the transition towards global net zero emissions. 'Climate Paris Aligned ETFs offer a suite of broad equity exposures designed to reduce fossil fuel exposure, mitigate transition and physical risks, capture opportunities and evolve with the goals of the Paris Agreement', says Ryan Reardon, Strategist ETF Research & Strategy EMEA at State Street SPDR ETFs.

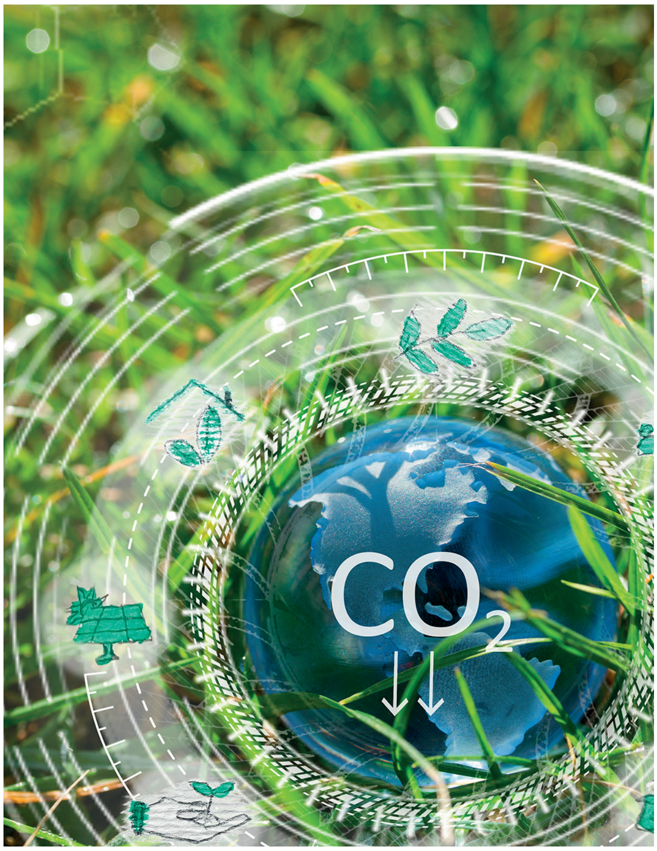

ILLUSTRATION: SHUTTERSTOCK

By *Wim Groeneveld*

How do you see ETFs fit into the investor journey towards climate investing?
'Investors have been expanding the use of ETFs for all asset management solutions in recent years and climate investing will be no exception. These funds enable investors to gain exposure to a diversified basket of securities, sharing a specific theme or classification, with the same speed and convenience of trading an individual security.

'The main difference between CTBs and Paris-Aligned Benchmarks is in how explicitly and aggressively they seek to align to the 1.5 °C scenario.'

This feature is what makes ETFs an effective tool for rules-based index investing. Climate conscious investors can change the carbon footprint of their portfolio by purchasing an ETF. The ETF, through its defined index methodology, can take responsibility of rebalancing its constituent exposures towards any stated climate goal.'

What do you see as main differences between Climate Transition Benchmarks (CTBs) and Paris Aligned Benchmarks (PABs)?
'The main difference between CTBs and Paris-Aligned Benchmarks is in how explicitly and aggressively they seek to align to the 1.5 °C scenario. CTB and PAB index strategies both share the primary objective of decarbonisation. CTBs are a decarbonisation strategy focused on protecting investors from risks associated with the transition to a low-carbon economy, labelled as transition risks by the Task Force on Climate-Related Financial Disclosures.

While similar, PABs will specifically exclude companies involved in businesses such as coal, oil and gas exploration, which may be allowed in CTBs. PABs contain a comprehensive decarbonisation solution aligned with the long-term global warming target of the 2015 Paris Agreement under the United Nations Framework Convention on Climate Change, also known as the Paris Accords.'

Is climate investing all about eliminating fossil fuel companies?
'Reducing or eliminating portfolio exposure to companies which have or

enable a high carbon footprint is a core component of climate strategies. But, climate investing is not simply about eliminating fossil fuel companies. PABs also seek to reduce greenhouse gas intensity without being underweight in high climate impact sectors.

By reallocating investment to companies in high climate impact sectors, with low carbon footprints, investors can reward companies which are decarbonising more successfully in line with climate transition goals. PABs also seek to increase their exposure to green revenues on both an absolute basis and as a ratio of existing fossil fuel revenues, which are labelled brown. These requirements can help portfolios target green opportunities which are working to address the climate transition risk.'

Are climate strategies underperforming significantly, now that energy companies are rallying? Is the outcome of climate objectives easily measurable?

'Any thematic index strategy will be subject to idiosyncratic performance based on the active portfolio risk it takes. In climate investing, that traditionally has meant a structural underweight to energy companies. It is important to recognise that core replacement PABs, which are strategies designed to replicate the market capitalisation weighted benchmark in terms of risk and return, will seek to make up for this over the fullness of any market cycle. The objective of a core replacement PAB strategy is to provide investors with similar market risk, but by investing in an aggregate portfolio which is aligned with the climate transition goals.'

How can investors achieve climate and net zero goals with Paris-Aligned portfolio strategies? What steps do you consider most important to integrate these strategies successfully in the investment process?

'PABs have two major components to specifically address the climate and net zero goals around alignment with the 1.5 °C scenario of the Paris Accords. The first is with respect to the self-decarbonisation pathway. The recommendation following the Paris Accords was for the global economy to reduce greenhouse gas emission by at least 7% per annum to be in alignment with the long-term decarbonisation goal.

The PAB index methodology goes above this, seeking to achieve at least a 10% reduction per annum. The second component is through an alignment metric such as climate Value-at-Risk (VaR), which is designed to provide a forward-looking and return-based valuation assessment to measure climate related risks and opportunities in an investment portfolio. The self-decarbonisation pathway and a climate VaR are critical components of a rebalancing methodology used by PAB strategies to help align a portfolio with climate and net zero goals.'

What factors pose the biggest challenge for integrating ETFs successfully to achieve climate targets?

'The biggest challenge for further developing climate investment solutions will be for the industry to adopt standards around language, taxonomy, data availability and reporting. While this will remain a challenge over time, it is encouraging to see such a strong commitment from regulators, index providers, fund managers, investors and portfolio companies to make progress in this area.'

To what extent does ETF investing allow the opportunity to influence and instigate positive change through engagement over time?

'In December 2019, the EU Technical Expert Group on Sustainable Finance Report on CTB and PAB Benchmarks pointed to the opportunity for investors to influence high climate impact companies through asset stewardship, with engagement and voting (Anti-Greenwashing Measures, page 14). We do believe asset stewardship is an important component of climate investing, as it helps engage with investee companies on ESG issues to seek long-term value. The expansion of climate themed-ETFs should give investors more tools to help influence positive change delivered both directly through asset stewardship, or indirectly through divestment.' ■

Ryan Reardon

Strategist ETF Research & Strategy EMEA, State Street SPDR ETFs

SUMMARY

Climate conscious investors can change the carbon footprint of their portfolio by using ETFs.

Climate themed-ETFs could at the same time be used as a cost-effective way to de-carbonise the core of equity portfolios of investors.

The biggest challenge for further developing climate investment solutions will be for the industry to adopt standards around language, taxonomy, data availability and reporting.

The expansion of climate themed-ETFs should give investors more tools to help influence positive change.