

The tracking error error: why climate alignment calls for bolder steps

Executive Summary:

- Investors who believe climate risks are significant and systemic should not aspire to doggedly track a misaligned market.
- With simplicity at their heart, win-win approaches that keep both carbon and tracking error low at an aggregate level can be misleading upon closer inspection.
- Investors wanting the highest impact should put climate science at the heart of portfolio construction and allocate capital to companies, across all sectors, that are on target to reduce emissions in line with science-based emission pathways.
- With data and analytics fast improving, tools such as climate alignment can help investors bring climate modelling to the heart of portfolio construction.
- The transition will not be linear. An active approach can allow investors more freedom to engage with and distinguish between companies that are already part of the solution, those that are credibly transitioning, and those that risk becoming obsolete.

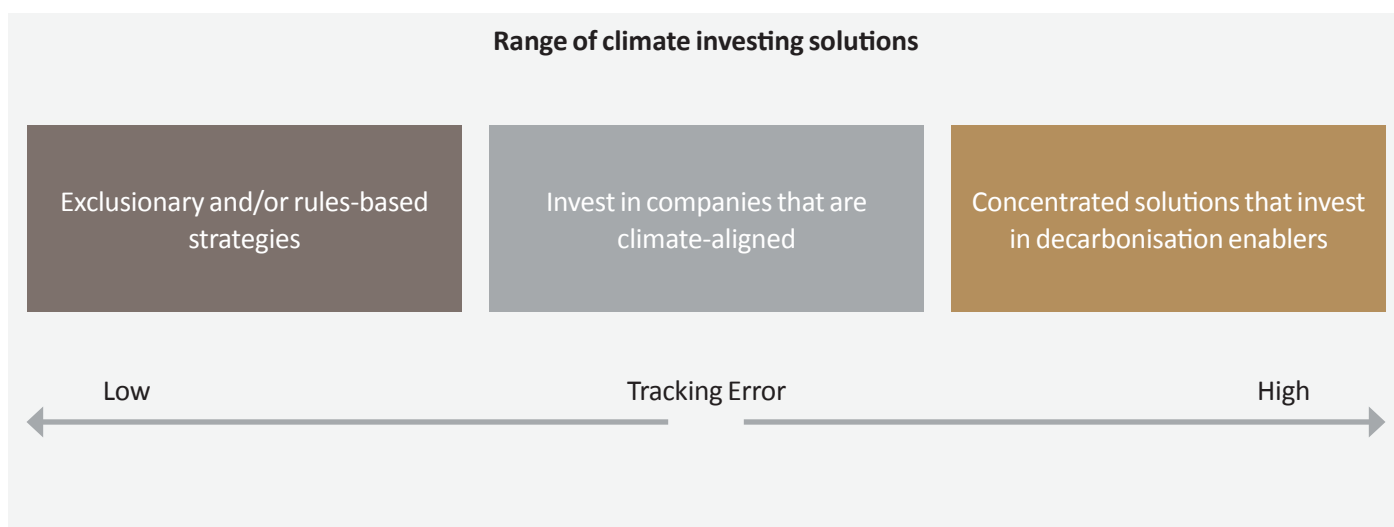
Bringing climate to the fore

The decades-old debate between active and passive investing features increasingly in the climate change investing space. Whilst we believe that both approaches can co-exist, we are of the view that fighting climate change today requires a willingness to actively deviate from current traditional benchmarks and the status quo.

In this thought piece, we attempt to shine a light on what each approach means in practice and highlight the salient points that investors should consider when assessing each as part of their portfolio construction process.

Tracking error spectrum

The current myriad of climate investing approaches can be classified on a tracking error,¹ relative to traditional market capitalisation indices, spectrum, as illustrated below. Typically, the lowest tracking error (TE) solutions consist of rules-based or exclusionary strategies (which 'tilt' the weightings of a given index, potentially with exclusions of sectors) while the highest TE solutions consist of concentrated portfolios which invest in technologies enabling decarbonisation. In the middle are solutions that invest in companies that are taking steps to align their business model to the net zero transition.²



Source: Fulcrum Asset Management LLP

1 Tracking error, also known as active risk, indicates how closely a portfolio tracks its benchmark. A low tracking error means that a portfolio closely tracks its benchmark, and vice versa.

2 Net zero transition is defined as the reduction of global anthropogenic CO₂ emissions to net zero by 2050 to keep the planet's temperature to below 1.5°C above pre-industrial times.

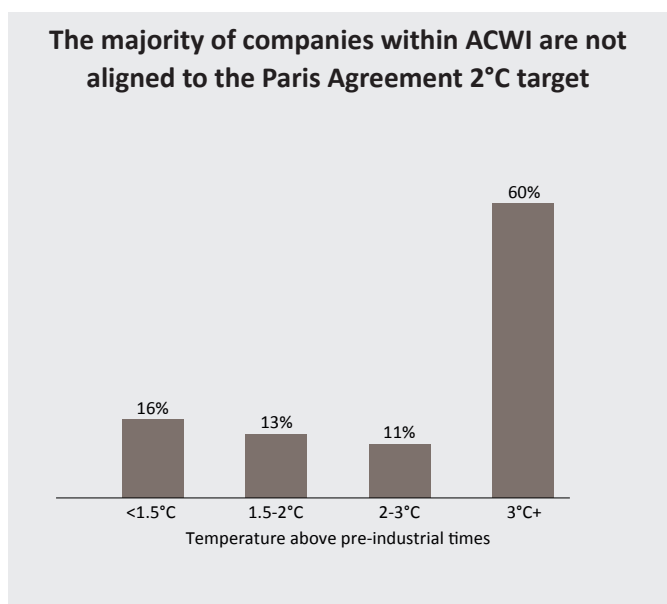
Theoretically, the multitude of approaches shown above can co-exist and cater to the preferences of different investors. However, individually, the solutions imply very different outcomes as regards financing the fight against climate change.

Low tracking error solutions

Solutions with low TE are often designed according to a set of rules, e.g., exclude highest emitting sectors, assign a higher weight to lower emitters, allocate more to companies with a higher share of green revenues, to name a few. Crucially, these solutions are often constructed to have as little deviation as possible to traditional benchmarks, possibly due to behavioural biases in favour of not deviating from the status quo and well-intended (but, we believe, insufficient) regulatory developments.³

Most listed companies today are misaligned to the Paris Agreement target of below 2°C. For example, the MSCI All Country World Index (ACWI) is not on track to stay below 2 degrees of warming above pre-industrial times. According to data from Trucost, MSCI ACWI is at 3.1°C. As shown below, the proportion of companies, by market capitalisation, within MSCI ACWI that are aligned to a below 2°C pathway is just under 30%.⁴

Hence, closely tracking traditional benchmarks is problematic. Instead of measuring how far an investment strategy is deviating from a misaligned market (via a metric like tracking error), it may be more impactful to consider the converse – how far today’s misaligned market is from a climate-aligned solution.

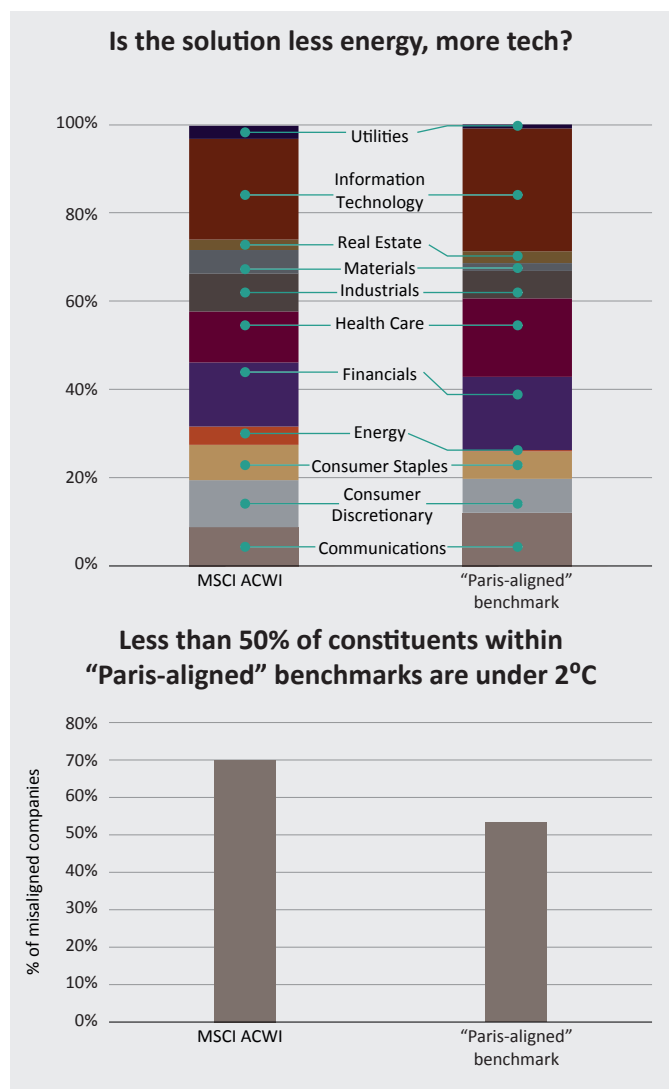


Source: S&P Trucost, Bloomberg LLP, Fulcrum Asset Management LLP as at 31st January 2022

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A risk we see is that of box-ticking by the overengineering of portfolio-level metrics (such as low tracking error to traditional benchmarks) without due regard for the true incentive signals sent to underlying constituents. One way this occurs in practice is through exclusions of high-carbon sectors such as energy (ticking the box for improving average portfolio climate metrics), even if much of the remaining stocks remain the same (ticking the low TE box).

As an example, less than 50% of companies in an equity index claiming Paris-alignment (PAB) are below 2°C.



Source: S&P Trucost, Bloomberg LLP, Fulcrum Asset Management LLP as at 31st January 2022

2 3 The EU’s Sustainable Finance Action Plan introduced two categories of indices: Paris-aligned Benchmarks (PABs), and their less onerous versions, Climate Transition Benchmarks (CTBs). The EU recommends these indices implement substantial carbon reductions upon launch and in each subsequent year, but without introducing significant sector deviations to their unadjusted versions. As discussed throughout this piece, these requirements may have unintended consequences.

4 We use the constituents of iShares MSCI ACWI ETF as a proxy for the broader market, as at 31st January 2022.

The reality is that all sectors must transition to a low-carbon economy. Blanket exclusions do not achieve this objective. Berk and van Binsbergen from Stanford University find that ESG divestiture strategies have had little impact and will likely have little impact in the future.⁵

Equally, overweighting certain sectors based solely on their carbon footprint is an ineffective strategy. In our view, “less energy, more information technology” is not charting a course for the transition to a low-carbon economy. As the current energy crisis has laid bare, restricting the supply of fossil fuels without alternative low-carbon solutions can be inflationary, with unintended social consequences borne by those who can least afford it.

Yet neither does remaining indiscriminately invested without robust engagement to motivate companies to step up on sustainability. It will take active engagement to help close the gap between leaders and laggards by holding companies and their boards accountable, with research showing that responsible investors can have significant impact by investing and exercising their rights of control to change corporate policy.

Transition pathways will differ across sectors and regions. They may even be non-linear – for example, consider the high resource requirements of some green technologies. It will thus take active, nuanced judgment – beyond merely partitioning companies into ‘good’ (low-carbon) and ‘bad’ (high-carbon) – to distinguish between the cost of transition between sectors.

Concentrated impact solutions

One may argue that companies did not shift away from analog to digital as a result of investor engagement; rather, the emergence of a superior technology triggered a sea-change. Similarly, there are suggestions that most financing should go to disruptive, green innovation – often presented as an Apollo program for this planet, not outer space.

Such investors will embrace the other end of the TE spectrum, via what are typically

concentrated portfolios which invest in decarbonisation solutions. Whilst technological solutions are crucial in the fight against climate change, the challenge is often deployment, not solely research and development, with research suggesting that we can decarbonise much of the world using solutions that have reached commercial viability.⁶

Moreover, the economics and maturity of existing technologies also vary substantially by sector, as do the dynamics between disruptors and incumbents. Not all climate solutions will be provided by outsiders, like Tesla, shaking up entire industries. In sectors with higher barriers to entry, such as steel or cement production, the incumbents may be those that develop the alternatives, even if their overall emissions profile may render them ineligible for inclusion in some of the strategies outlined above.

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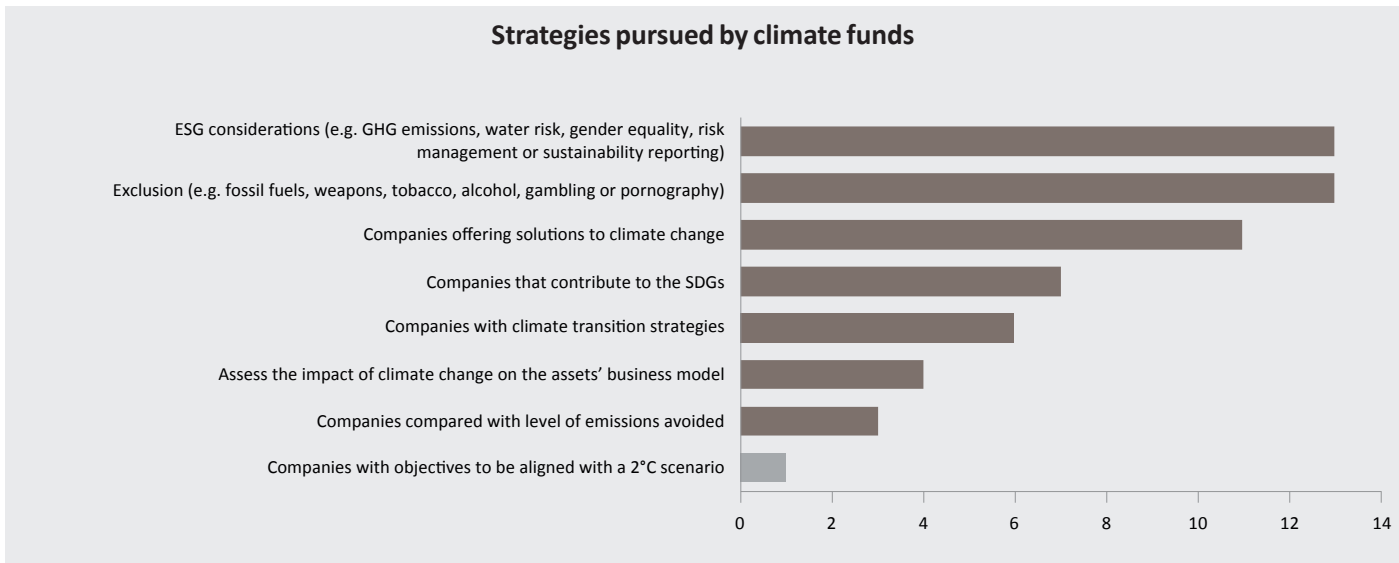
Hence, globally diversified portfolios that are truly aligned – for example by only investing in firms on a below 2 degrees trajectory – combined with robust engagement, have the greatest potential to lead to substantial finance flows towards fighting climate change.

Globally diversified solutions investing in companies aligned to the Paris Agreement temperature target

These diversified solutions lie in the middle of the spectrum we illustrated at the start of this article. They aim to invest in companies that are taking steps to align their business model to the net zero transition. Given the scarcity of companies below 2°C today, these solutions take an active decision to deviate in a meaningful fashion from traditional benchmarks whilst still providing investors with minimal sectoral and regional deviations.

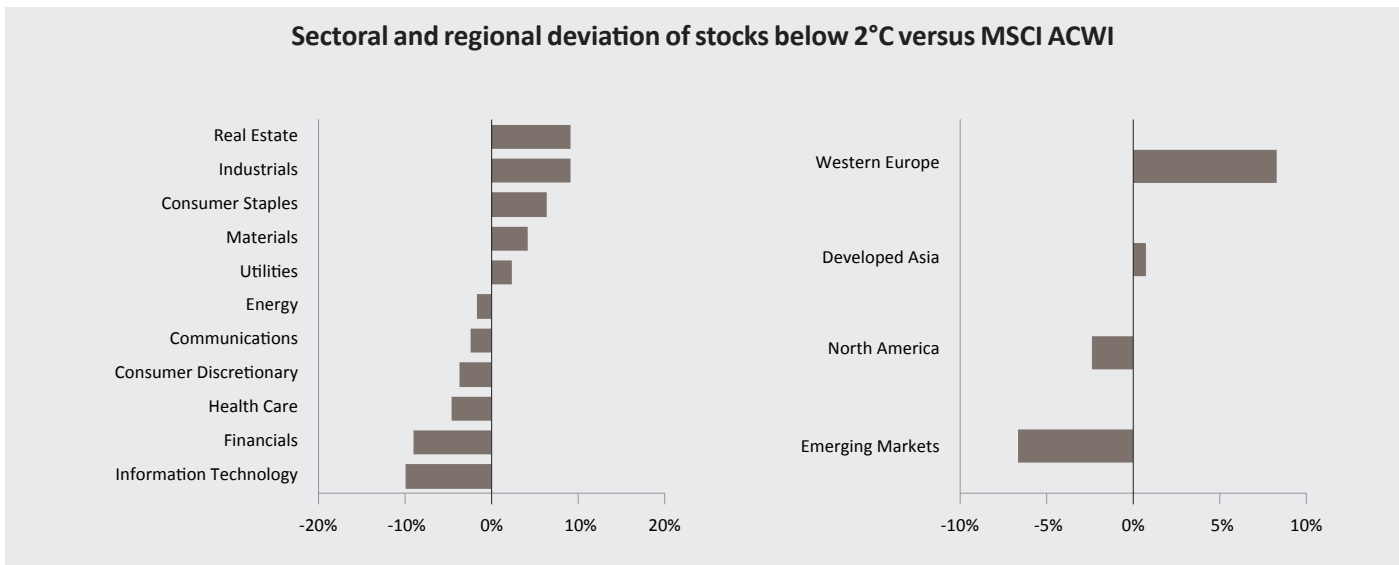
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Research from Cambridge Institute for Sustainability Leadership (CISL) suggests such solutions are currently rare in the market; out of the five funds that had an objective to build a portfolio aligned with the Paris ambition, only one chose the underlying constituents to be based on their alignment with a 2°C scenario.



Source: Cambridge Institute for Sustainability Leadership (CISL)

We believe that such solutions have, to date, been absent from the market given the challenges in creating such a portfolio. Below, we illustrate the deviations in terms of sectors and regions imposed from constraining the investment universe to companies below 2°C. In our view, strategies seeking to minimise any sectoral and regional biases from the outset will struggle to, firstly, meet climate constraints and, secondly, maintain a very low tracking error relative to traditional benchmarks.



Source: S&P Trucost, MSCI, Bloomberg LLP, Fulcrum Asset Management LLP, as at 31st January 2022

Final word

With the world today not on a pathway consistent in keeping temperatures below 2°C (let alone 1.5°C) above pre-industrial levels, using traditional benchmarks as a strict gauge (as measured by minimal tracking error) to construct climate change portfolios is unlikely to solve the climate issue.

The tension is that many investors who profess to have a long-term investment horizon, upon which climate concerns are said to register ever more menacingly, nevertheless chain themselves (including their designated managers) to what

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is at best a short-term financial measure (tracking error), but certainly not a measure of climate performance.

Investors who want to have the highest impact should be willing to deviate from the status quo instead of tinkering at the edges of their portfolios. Bringing climate change to the heart of portfolio construction means efficiently allocating capital to companies, across all sectors, that are reducing emissions in line with science-based emission pathways, in addition to making engagement a core part of the investment process.

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