Index investing and the climate crisis

Focus

We explore the role of index investors in slowing down the impact of climate change.

Finding a balance

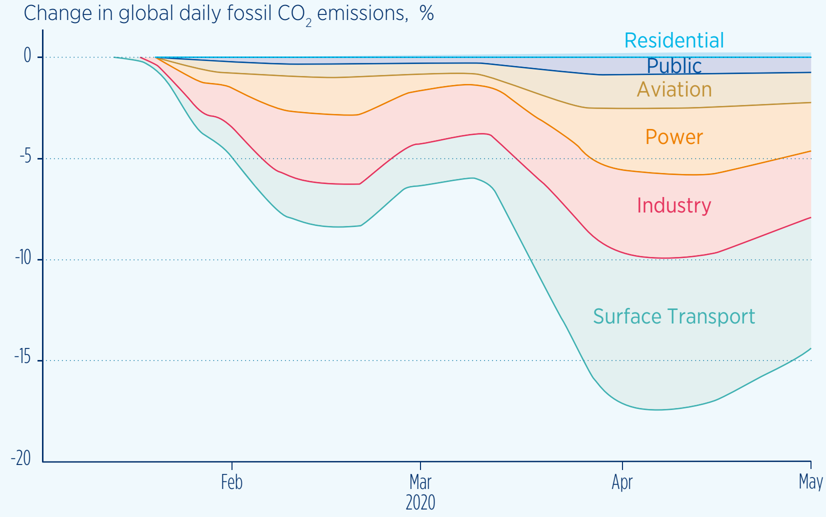
The planet is getting hotter. According to the World Meteorological Organization, 2015-2019 was the warmest five-year period since records began[1]. We are all aware, by now, of the climate emergency- and of the fact that we have only ten years, at most, before reaching the point of no return.

While the Covid-19 crisis this year has had a devastating effect on society and global economies, it has had a positive impact on carbon emissions and has shown us all that it is possible to reduce our carbon emissions drastically. The goal now is to find a happy balance as we reignite global economies.

One thing is clear; governments cannot solve the problem on their own. So how can the investment industry play its part?

Environmental impact of Covid-19 pandemic

Change in global daily fossil CO_2 emissions, %



Source. Le Quéré et al. Nature Climate (2020); Global Carbon Project.

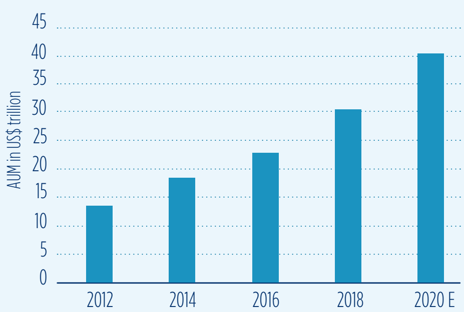
The central role of asset management

By the end of 2019 close to $90 trillion of assets were being managed by Asset Managers around the world[2] - to put that into perspective, it is approximately five times the GDP of all the countries in the European Union combined! With such large amounts of money to invest, Asset Managers have a real opportunity to drive sustainable change around the world.

As recently as four years ago, environmental, social and governance (ESG) investing was quite a niche approach, popular in Europe but not widely embraced… however it is estimated that the incorporation of ESG data in investment decisions has almost doubled since then – now reaching just over $40 trillion, or almost 45% of all assets under management.

Growing investment use of ESG data

Evolution of AUM invested in funds leveraging ESG data



Source: GSIA, Opimas

Much of this growth stems from investor demand and increasingly from the requirements of regulators around the world, whether local schemes or regional initiatives such as the EU action plan. ■

1. World Meteorological Organization, 15 January, 2020
2. BCG article, Global Asset Management 2020: Protect, Adapt, and Innovate (May 19, 2020)

Is climate truly an investment topic?

Climate change is not just a matter for the media, young people or environmentalists; it has become a key topic for investors around the world. There are several reasons for this shift, the first being a question of investment risk management as climate change is closely associated with asset-specific risks. Identifying these risks and accounting for them in the investment process will lead to better long-term investment decisions.

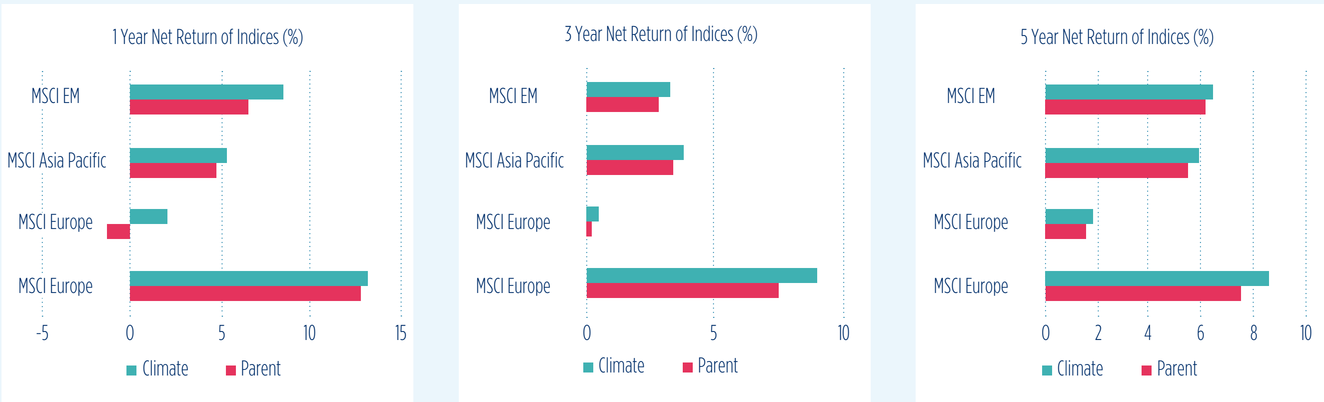
Climate-associated risks

- Transition risk: assets at risk of being negatively impacted by incoming climate regulation or low carbon technologies e.g. coal mines
- Physical risks: assets at risk of being negatively impacted by the increasingly severe weather related events

On the upside, the investment opportunities arising from the energy transition could actually outweigh climate-related risks in the long term. This leads us to the second reason for climate change to be considered an investment topic – investors do not like to miss return opportunities and climate investments have shown some promise in terms of their risk-return ratio. An analysis of MSCI climate indices over the past five years is a simplistic indicator of this, across all time periods and geographies, the climate version of the index has shown consistent outperformance compared to the parent index.

A further reason for the climate to be an important consideration for investors is the evolving regulatory landscape. In 2015, the French Energy Transition for Green Growth Act set a global precedent by requiring investors to be transparent about the climate impacts of their investments. In other countries where there is no equivalent regulation, local industry bodies are stepping in with recommendations. For example, the Swiss industry association of asset managers SFAMA together with the Swiss Sustainable Finance organisation for sustainable investment recently published recommendations for the implementation of ESG concepts, and in the UK, the FCA's Climate Financial Risk Forum has now published a guide to help the investment industry address climate-related risks. ■

Positive Climate Index Performance



Past performance does not guarantee and is not indicative of future results

Source: MSCI as at 31 July 2020 (Indices shown are MSCI World Climate Change Index, MSCI EM Climate Change Index, MSCI Europe Climate Change Index and MSCI AC Asia Pacific Climate Change Index)

The practicalities of considering climate

Investors looking to incorporate climate into their portfolios historically focused on impact investing strategies or active investment solutions. The primary reason for this in the past was the inability of index approaches to stock pick or under/overweight companies. While impact or active approaches are good for some investors for certain aspects of their investment strategy, they are not always the answer.

Index approaches to climate investing do exist, and have done for some time; in fact, Amundi were at the forefront of low carbon index innovation when they co-developed the MSCI Low Carbon Leaders index series with FRR and AP4 in 2014. The indices were a ground-breaking development when they were created, but improvements in data quality and availability have now opened the door to a new generation of climate indices which can consider indirect emissions and forward-looking climate commitments alongside historical data. With the further addition of comprehensive climate index labels from the European Union, investors are able to use index investing to incorporate climate goals in their portfolios more effectively. ■

The EU Benchmark labels

In 2018 the EU assembled the Technical Expert Group, a panel of experts from the investment industry, academia and sustainability practitioners to develop climate index labelling – resulting in the EU Climate Transition Benchmark (CTB) and Paris-Aligned Benchmark (PAB)[3] labels, the first pan European labels for sustainable investment indices.

In doing so, the EU has provided investors with a clear and transparent framework for sustainable investing and highlighted the important role of index management in the transition to a low carbon economy.

The PAB and CTB labels require specific levels of "self-decarbonisation" of the index year-on-year as well as ambitious carbon intensity reductions versus the parent index. PAB labelled indices also require specific activity exclusions. Together, the benchmark labels offer a structure for index providers and asset managers to facilitate widespread, cost-effective climate investing. And, the wider climate investing reaches, the greater the impact it will have. ■

Amundi's Climate ETF Range

Having been instrumental in developing the early low-carbon indices, and with a long-standing commitment to sustainability, Amundi was one of the first asset managers to launch ETFs managed to the new EU climate indices. The range covers investors' core geographies with PAB labelled funds alongside a series of climate change ETFs that are expected to meet the criteria of the CTB label[4]. This allows investors to incorporate climate at the heart of their portfolios simply, cost-effectively and in a way that matches their objectives.

The Amundi ETF climate solutions use indices that follow comprehensive positive- and negative-screening, reweighting and scoring methodologies to deliver on their carbon reduction objectives.

EU Climate Benchmark Methodology

Additionally, they use historical data on emissions scope 1 (direct), scope 2 (purchased electricity) and scope 3 (all other indirect emissions) of greenhouse gas emissions to explicitly allocate to the most climate positive companies. This backwards-looking analysis is combined with forward-looking approaches that consider company strategy and the transition risks associated with carbon emissions. ■

Driving impact with climate index investing

When selecting an index approach to climate investing, the first step for investors is to choose a suitable climate index, however, equally important is the selection of an asset manager. Identifying a manager who has a robust engagement and voting strategy aligned with the goals of the index can play a key role in achieving climate investment goals. For example, an asset manager who manages a climate ETF but votes against climate-related shareholder proposals or does nothing to discourage lobbying with negative environmental consequences would ultimately disappoint an investor seeking real climate impact.

Amundi has a comprehensive engagement strategy comprising continuous engagement, an active voting policy (which saw Amundi vote against management in 55% of shareholder meetings in 2019) and targeted impact engagement on core themes such as environmental strategy, energy use and biodiversity. It is with this foundation that Amundi launched the Euro iStoxx Climate Ambition ETF which was consciously designed to encourage impact through engagement. By systematically overweighting securities with Science Based Targets, the index was designed to incentivise companies to commit to the Science Based Target initiative[5] and disclose their carbon footprint reduction emission plans.

Over recent years asset manager engagement has resulted in tangible change across a range of sectors, container shipping companies committing to net-zero targets, and food and beverage manufacturers reporting on scope 3 emissions. Also, oil and gas companies have committed to link executive pay to climate targets, according to the *Climate Action 100+ 2019 Progress Report*[6].

Exclusions, divestment and engagement can all be achieved in passive investment strategies, and it is important to select a fund manager who not only "talks the talk" on ESG issues, but also "walks the walk". ■

Engagement or divestment?

According to the PRI in 2015[1], one of the key reasons investors use active approaches to address climate concerns is the inability of index funds to exclude securities.

While divestment sends a clear signal that a company or sector is not doing enough on ESG issues, it quashes engagement by that investor and means there is one less responsible shareholder to put pressure on the company.

One downside of divesting from the oil and gas sector, for example, is investors no longer engage with firms large enough to pour resources into renewables projects.

Investors may prefer to continue to have exposure to controversial sectors while ensuring that their asset manager votes and engages on these holdings to drive sustainable change.

3. European Commission Delegated Regulation of 17.7.20 supplementing regulation (EU) 2016/1011 as regards minimum standards for EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks. This regulation sets out minimum technical requirements for EU Climate Benchmarks, as well as a number of environmental, social and governance (ESG) disclosure requirements.
4. Pending index compliance with the CTB label, or an index change 5. For more information visit sciencebasedtargets.org 6. Amundi is a signatory of Climate Action 100+, an initiative bringing together over 450 investors with over $40 trillion in AUM to tackle climate changes by influencing the behaviour of 161 of the world's largest greenhouse gas emitters. Visit climateaction100.wordpress.com for more information.

Responsible Investing at Amundi ETF, Indexing and Smart Beta

Amundi was established in 2010 with responsibility as a core belief and was one of the founding signatories of the UN Principles for Responsible Investment[7]. In 2020 Amundi was awarded an A+ across all categories in the PRI[8] assessment.

Amundi offers a broad range of ESG investment solutions and has an extensive engagement and voting policy, applied equally across both active and index.
This comprehensive approach to engagement was recognised in the 2020 Shareaction UK report which analysed the world's largest asset managers on their approaches to responsible investing. Amundi was rated a BB and ranked 15th, the highest rating of any top-10 asset manager by AUM. ■

A wide range of esg equity and fixed income ETFs

Cost-effective core building blocks designed to allow you to build a responsible investing solution to meet your needs.

ESG			Climate	
+	++	+++	++	+++
Broad market exposure with enhanced ESG score	Best-in-class approach with a controlled tracking error	Best-in-class approach combined with strict negative screening	Transition towards a low carbon economy with broad market exposure	Accelerated transition towards a low carbon economy with GHG intensive activity exclusion
World - US - Europe Eurozone - EM	World - US - Europe	World - US - Europe Eurozone - Japan - EM	World - Europe	World - Europe Eurozone

For more information about using ETFs to make a positive climate impact, visit amundietf.com/responsibleinvesting or email us at info-etf@amundi.com

7. The PRI was founded in 2005 with Credit Agricole Asset Management as a founding signatory. Amundi was borne of the merger of Credit Agricole Asset Management with Société Générale Asset Management in 2010.
8. For more information visit unpri.org and view the 2020 transparency reports.