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How climate metrics can guide institutional investors towards their net zero goals

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Every investor is affected by the policy, regulatory and consumer momentum around climate change. The effects will be steadily amplified, and the risks become more visible in every asset class and every portfolio. As the powerful drive to deliver on the targets of the Paris Agreement gathers pace, it is essential for investors to understand where those risks are, how potent they might be, and how they will likely evolve over time.

We typically see three types of investors: Those simply happy to comply with the regulations; others seeking to identify and address climate risks, and; those who decide there is little point running a net zero portfolio in a net positive world and who want to support the wider transition.

In short, no institutional investor can ignore this ubiquitous trend. The physical and transition risks associated with climate change pose a genuine financial risk whichever type of investor you are. The aphorism – 'what can be measured can be managed' – has rarely felt so appropriate.

However, this is still a new and complex area where the available data must be analysed closely to deliver decision-useful insights that can prepare and protect investor portfolios for a net zero world.

Measure for measure

Three important metrics are a common starting point to assess the climate impact of portfolios:

- **Total emissions:** The simplest and most fundamental metric. This measures the level of greenhouse gas (GHG) emissions in a portfolio – if you own 10% of a company, you own 10% of its emissions. This datapoint, measured in tonnes of CO_2 equivalent (CO_2e), will decide if a portfolio has reached net zero.

- **Carbon footprint:** This translates total emissions into a measure per million invested, making it a far better tool for comparisons. Combined with total emissions, it is a favoured measure of regulators including the UK's Department for Work and Pensions.

- **Weighted Average Carbon Intensity:** Known as 'WACI', this looks at the emissions intensity of all issuers in a portfolio weighted by a measure of scale, typically revenues but possibly others such as enterprise value or something sector-specific. It is particularly useful when comparing assets within industries.

In combination, these metrics start to form the basis of climate reporting. Overleaf we set out how this might appear, with additional benchmark performance and coverage data to put the results in context. This kind of reporting can go a long way to meeting the metrics demands of the Task Force for Climate-related Disclosures (TCFD).

Figure 1: Climate reporting – example emissions report

Scope 1 & 2 carbon emissions	Portfolio	Coverage	Benchmark	Coverage	Units
Absolute emissions	36,540	72.0%	50,900	76.8%	tC02e
Carbon footprint	83.7	72.0%	138.1	76.8%	tC02e/m GBP Invested
Weighted Average Carbon Intensity (revenues)	100.6	68.5%	108.6	73.6%	tC02e/m USD Revenue
Weighted Average Carbon Intensity (Total Enterprise Value - TEV)	61.6	72.0%	96.8	76.8%	tC02e/m USD TEV

Scope 3 carbon emissions	Portfolio	Coverage	Benchmark	Coverage	Units
Absolute emissions	249,263	63.5%	804,433	75.5%	tC02e
Carbon footprint	571.0	63.5%	2,182.6	75.5%	tC02e/mGBP Invested
Weighted Average Carbon Intensity (revenues)	813.6	60.6%	649.24	72.8%	tC02e/m USD Revenue
Weighted Average Carbon Intensity (Total Enterprise Value - TEV)	425.3	63.5%	1,570.2	75.5%	tC02e/m USD TEV

Source: AXA IM, Trucost, Bloomberg as at 30/06/21. For illustrative purposes only.

Scopes 1 and 2 refer to the direct and indirect emissions from business activities. Scope 3 relates to the emissions attributable to the use of products or services by suppliers and consumers and tend to be harder to gauge and can sometimes rely on inconsistent estimates. Therefore, we urge caution when analysing and reporting on these figures.

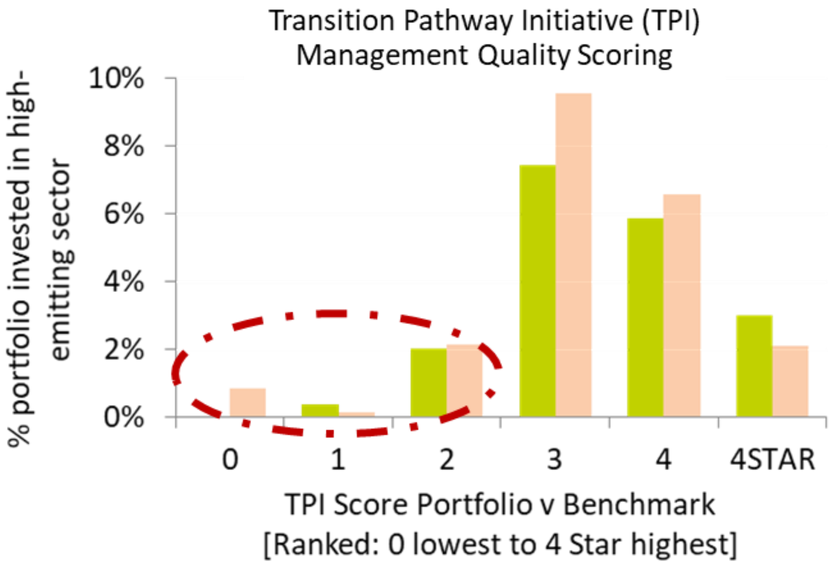
Risks and resilience

While the ‘big three’ metrics form the cornerstone of climate reporting, we believe more nuanced measures are required for credit investors to properly assess the financial implications of climate risks.
One route is to use Climate Value at Risk, or CVaR, in effect a scenario-analysis tool to measure how much a portfolio might fall if climate risks are fully priced in today.

We can use CVaR to identify the main contributors to risk and better understand the potential financial impacts. Any increase in carbon pricing, for example, could quickly upset business models for high-emitting companies.

An alternative would be to deploy insights from the Transition Pathway Initiative (TPI), an asset-owner-led group that scores companies' preparedness for the low-carbon economy. It is forward-looking, sector-specific, and freely available – its only real drawback is that it looks only at the most material emitting industries. Notably, it doesn't cover financials, which may be financing high-emitting companies.

Figure 2: Assessing a company's preparedness for the low-carbon economy



Source: AXA IM, Transition Pathway Initiative, 30/06/21. For illustrative purposes only. TPI Management Scoring shows portfolio holdings versus benchmark for high emitting sectors, ranked from Level 0: Unaware of Climate Change as a Business Issue, through Level 4: Strategic Assessment to 4 Star, its highest ranking.

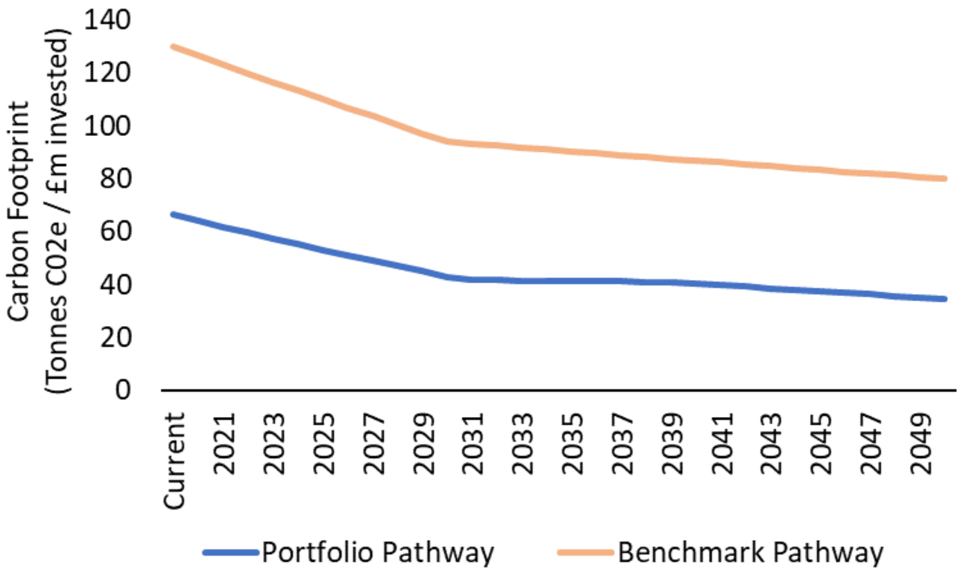
Align at last

At the heart of climate-aware investing is alignment with the net zero pathway of the global economy. To address this, we begin by looking to the Science-Based Targets initiative (SBTi), a third-party provider which checks and approves company targets against Paris Agreement scenarios and across more sectors than the TPI.

We then use the SBTi input to carefully plot how those targets translate into the expected carbon footprint over time. The graphic below indicates how we might assess this in a sample portfolio – we would expect the portfolio pathway to steepen as more companies make commitments, and as engagement work bears fruit.

For institutional investors using buy and maintain credit or cashflow driven investing strategies, we can build a bespoke carbon emissions portfolio integrating their unique goals:

Figure 3: Projected emissions pathway



Source: AXA IM. For illustrative purposes only.

Conclusion

Investors get it. The Net Zero Asset Managers Initiative now covers some $43trn in assets under management[1], but this still feels like the drawing of breath before the real work is done. And it is important not to lose sight of perhaps the most fundamental aspect of climate-aware investing: It should not come at the expense of the investors' financial objectives.

To do that, multiple sources of data must be harnessed, analysed, and deployed. All that we have discussed above and more can be combined to form an over-arching climate dashboard that gives institutional investors the opportunity to adapt credit allocations over time and with confidence that they may be better protecting portfolios against one of the most dominant risk factors of our time.

Investments involve risks including loss of capital.

[1] https://www.netzeroassetmanagers.org/#

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The ESG data used in the investment process are based on ESG methodologies which rely in part on third party data, and in some cases are internally developed. They are subjective and may change over time. Despite several initiatives, the lack of harmonised definitions can make ESG criteria heterogeneous. As such, the different investment strategies that use ESG criteria and ESG reporting are difficult to compare with each other. Strategies that incorporate ESG criteria and those that incorporate sustainable development criteria may use ESG data that appear similar but which should be distinguished because their calculation method may be different.