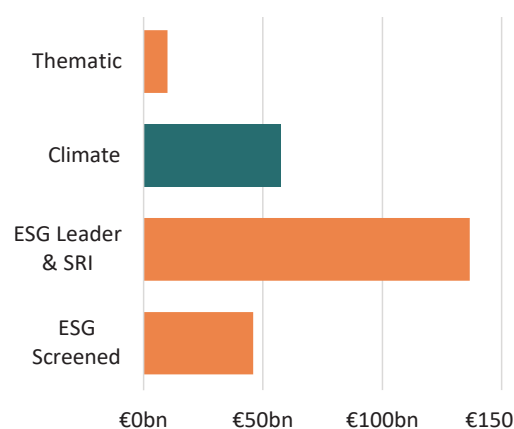


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Degrees of climate investing: decarbonisation on paper and in practice

Over the past years, sustainability considerations have permeated the investing space. While traditionally utilised for risk reduction, ESG investing has evolved to not only consider exclusion-based approaches but covers many different areas of sustainability and strategies to translate these into portfolio construction. As almost 90% of global emissions are covered under net zero targets,¹ also a growing number of investors wish to specifically focus on climate in their investments. Over the last three years, this development was underscored by significant inflows in climate-related ETFs as they received a quarter of overall ESG UCITS inflows.²

Figure 1: ESG UCITS ETF assets under management



Source: DWS International GmbH, as of March 2023. ESG Screened describes exclusion-based strategies with active share around 10%, while ESG Leader & SRI approaches follow stricter exclusions and only invest in companies with the best ESG scores in defined areas. Climate products focus on the climate transition and may replicate a regulated Paris-aligned or Climate Transition Benchmark. Thematic funds often focus on certain societal or economic trends, such as emerging technologies

Investors may have many motives to turn to ESG and specifically climate investing, among which risk, regulation and the rise of investor-specific climate targets may be the most salient ones. The risk reduction argument has been broadened to include physical or transition risk arising from companies' (poor) management of climate risks. Regulatory requirements have for the first time provided clarity on specific investments – with the delegated act on Paris-aligned (PAB) and Climate Transition (CTB) Benchmarks, the European Union has provided a clear framework on what such benchmarks must achieve. Additionally, more and more institutional investors have specified decarbonisation targets for their invested assets, prescribing in turn that portfolios must guarantee a hard-wired carbon reduction path. Owing to the different motives, investors may turn to different

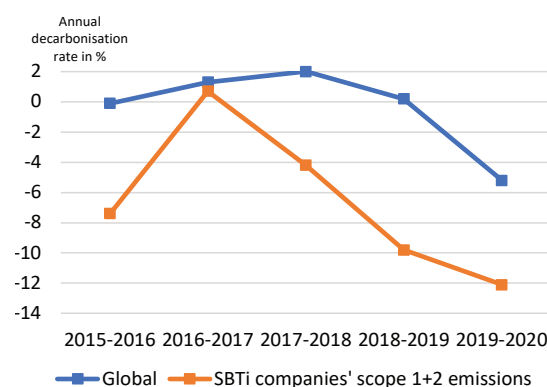
investment strategies. The well-known SRI approach is one way to achieve risk reduction through divestment, while pathway strategies can be more inclusive and green bonds offer the possibility to directly re-allocate capital towards projects with an environmental focus such as the provision of renewable energy.

When talking about ESG investing in general, the ethical aspect should of course not be discarded – after all, many exclusions are based on the consensus that certain activities are controversial and one should not profit from these businesses. The next step would then be to ask how investors can influence the real economy and the companies they are invested in (or have divested from). Especially when it comes to climate investing and the associated race to the bottom of portfolio emissions. One must ask what role such investments can play in the climate transition – how can carbon emission reduction at investment portfolio level (put bluntly, “on-paper” decarbonisation) support tangible real-world decarbonisation outcomes? Reducing portfolio emissions can be achieved with ease. For example, merely excluding around 3% of the weight of the MSCI ACWI IMI can reduce index emissions by 50%.³ Similarly, strict exclusion-based methodologies like the SRI standard often achieve considerable decarbonisation versus their benchmark accompanied by notable improvements in other ESG metrics. In this context, investors can influence asset prices and ultimately the cost of capital for the divested companies. In a financial context, a ‘law of large numbers’, indicates that a large enough withdrawal of investor money should increase the true cost of refinancing due to the resulting decrease in equity value.

Consequently, this should also act as an incentive to improve on ESG metrics – and may provide a chance to link decarbonisation on the portfolio level and in the real world: Evidence suggests that companies with approved science-based targets (SBT) outpace the broader economy in their decarbonisation.⁴ This offers a compelling case to incorporate SBTs as a variable in portfolio construction. Such an approach can offer benefits to the investor and society at large: The investor has some confidence in the stability of their portfolio and potentially reduced future turnover due to changes in company climate metrics. Moreover, from a financial perspective, companies that have validated their 1.5°C target have seen a widening in their economic P/E compared to companies with less ambitious or no target.⁵ From a societal perspective, companies that have set SBTs are obliged to pursue them and transparently report on their progress in real-world decarbonisation.

Yet, the cost of capital effect also unveils a conundrum of ESG investing: The portfolio that appears most impressive in terms of its ESG performance may only

Figure 2: Gross scope 1+2 emissions' change rate of companies with approved targets vs the global economy



Source: Science-based Targets Initiative (SBTi) Progress Report 2021.

translate into real-world change over a relatively long time horizon. Fortunately, investors have additional levers at hand to contribute to positive sustainability outcomes. According to the European Union, an equity PAB portfolio must not decrease its aggregate exposure to sectors with especially high contributions to climate change, the so-called High Climate Impact Sectors, with the aim of remaining representative of the real economy.⁶ By retaining exposure to these activities, investors can leverage stewardship and engagement to incentivise change.

The most direct way for public-market investors to support the climate transition may however lie in the fixed income space, which is often overlooked due its less clear route of engagement. Green bonds are a uniquely positioned instrument to help (re-)finance transitional activities and support the development of new technological solutions in the short-term – an immediate lever that is often elusive in the realm of liquid equity markets. Nonetheless, one should not jump to the conclusion that only investments with a direct way of supporting green projects are appropriate climate investments. Different investor goals warrant different strategies and in climate investing, it is important that investors seek dialogue through engagement as well as phase out investments in activities that cannot have a long-term place in a net zero future.

Xtrackers
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FOOTNOTES:

- Climate Action Tracker, as of November 2022
- DWS International GmbH calculations, as of March 2023
- DWS International GmbH calculations, as of 27/02/2023. Index emissions calculated as weighted average carbon intensity: Scope1+2 emissions / sales
- Science-based Targets Initiative (SBTi) Progress Report 2021.
- DWS Research Institute, as of November 2021. Economic P/E is defined as enterprise value (EV) over net capital invested (NCI) divided by cash return on capital invested (CROI): (EV/NCI) / CROI.
- <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R1818&from=EN>

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