

SPONSORED COMMENTARY

In EMEA for Professional Clients (MiFID Directive 2014/65/EU Annex II) only. In Switzerland for Qualified Investors (Art. 10 Para. 3 of the Swiss Federal Collective Investment Schemes Act (CISA)). In Australia: for Wholesale Investors only.

Navigating the climate index jungle

The need to understand Climate benchmarks and their personalities

The rise of climate investing can offer distinctive allocation opportunities, but it has also complicated the task of decarbonisation. In the past, most investors tended to focus on mitigating climate risk, often by excluding the fossil fuel sector. While this practice, which we would now call “paper decarbonisation”, still results in impressive low carbon metrics by today’s standards, investors should be very aware that this is a side effect. It will not be news to investors that exclusions alone may not be the best way forward in an area that requires strong engagement and active ownership.

The need for a fundamentally different approach has given rise to a whole new field of climate benchmarks that aim to achieve multiple objectives, such as reducing the carbon intensity of an investment portfolio, allocating to climate investment solutions or aligning with a specific climate pathway. These innovations are timely, as heightened geopolitical risk and record temperatures on land and sea are driving investor ambition and regulatory action on climate change.¹ Climate change has already become the largest dedicated investment theme within the ESG universe, but as investor confidence in this area has grown, allocation options have also branched out - resulting in a jungle of different benchmark approaches.

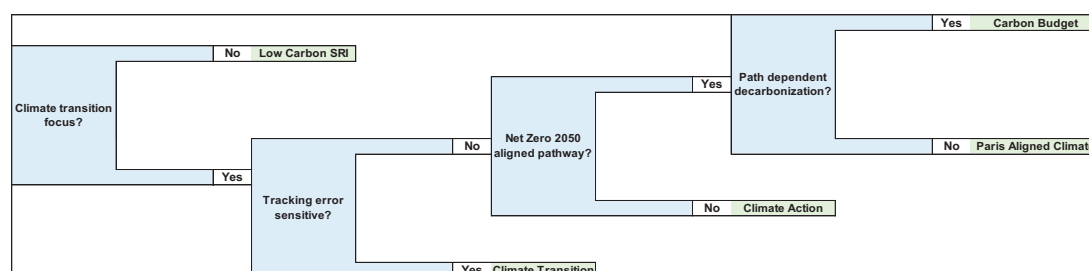
These include regulation-driven benchmarks such as the EU’s Delegated Act-linked Climate Transition (CTB) and Paris-aligned Benchmarks (PAB), as well as more recent, non-regulated benchmarks such as the Climate Action or Carbon Budget approaches.

A closer look reveals that each of these indices has its own philosophy and that the differences are probably best seen through a myriad of lenses, such as carbon footprint, self-decarbonisation, fossil fuel exposure, exclusion of corporate sector activities and green revenues - which may seem like a jungle of options. Reducing the complexity of investor choice to a few key inflection points can help investors find their path.

As noted above, traditional ESG approaches, while effective in improving portfolio-level metrics, are fundamentally different and not fully suited to climate investors who need to meet internal and external climate commitments. They also differ from climate investment approaches in another key dimension - their tracking error, also known as active risk, relative to the base universe. Highly exclusive indices inevitably filter the universe significantly, increasing exposure to individual companies, and while this is logical, the broad exclusion of the energy and large parts of the utilities sectors has also been a major driver of performance deviation over the past 18 months.

By design, climate investing offers a different approach as indices necessarily seek to reflect a much broader representation of the underlying economy. For the EU-regulated benchmarks, the regulator has highlighted that this realistic representation is key – it is not about achieving the highest ESG scores or lowest

Figure 1: Indicative decision tree which can help select appropriate climate index benchmark



Source: DWS Research Institute (August 2023)

carbon footprint, but rather about building a portfolio that is consistent with an economy transitioning to a net zero emissions future. For tracking error-conscious investors, CTB approaches may be a sweet spot. A CTB World strategy removes only around 400 from the 1600+ names of the MSCI World index, resulting in a very moderate tracking error of typically less than 100 basis points, which remains a meaningful threshold for many investors.

In an ideal world, an investor would expect both tracking error and tracking difference to be as close to zero as possible to minimise the implementation risk of a climate strategy. For some long-term investors, a tracking difference may even reflect part of the original investment case, as the de-risking and financial returns associated with climate leaders could lead to a greater divergence in performance. Tracking error is then seen as a shorter-term risk, but for many investors venturing into climate investing, it is arguably the more relevant consideration.

Managing the potential risk of tracking error is one of the most important tasks for climate investors. Not only the EU benchmarks, but many others, are designed to be long-term allocations, and their power only unfolds over longer holding periods as lagged engagement efforts are initiated. Tracking error is therefore a useful indicator of short-term risk, and investors must be willing to accept this level of short-term risk.

For an investor willing to accept risk in return for a portfolio geared towards a net zero 2050 pathway, the latest index innovations have opened two further pathways: The first contains the aforementioned EU-regulated benchmarks, specifically the Paris-aligned version which calls for stricter decarbonisation requirements as well as fossil fuel exclusions. The second is not regulated but also based on scientific evidence: A carbon budget approach relies on the total emissions available in limiting global warming below 1.5°C. In its purest form, this approach can be more inclusive than a PAB index as it applies a constant portfolio decarbonisation rate that is sector-agnostic. As we get

closer to 2050, the available carbon budget decreases – current figures estimate an annual usage of around 40bn tonnes of CO_{2e}.² Consequently, the decarbonisation pressure increases with time – the later action is taken the higher the annual decarbonisation rate will be. This provides investors with an almost unique opportunity to influence tracking error: Starting the journey towards climate transition earlier will be rewarded with lower active risk.

In summary, any benchmark choice reflects a trade-off, but given the novelty, investment horizon and proportion of the portfolio dedicated to climate strategies, it appears to be one of the most important faced today. Selecting the appropriate climate benchmark is a function of key targets and objectives such as carbon intensity reduction, pursuing a decarbonisation pathway, the appetite for issuer exclusions, capturing climate investment solutions, and whether tracking error constraints exist. In most cases, reducing portfolio emissions is the primary goal. Such portfolio emission reduction is straightforward, as merely excluding 3% of the weight of the MSCI ACWI IMI can reduce index emissions by 50%.³ Yet, the devil is in the detail and a decision tree like the one we propose to navigate the climate index jungle can help in selecting a benchmark that reflects climate objectives, motivations and investment constraints.

If you enjoyed this executive summary, please find our full report on how to navigate the climate index jungle on the Xtrackers website.

FOOTNOTES:

- 1 Reuters (July 3, 2023). World hits record land, sea temperatures as climate change fuels 2023 extremes
- 2 Based on MCC Carbon Clock, November 2023
- 3 Based on MSCI and MSCI ESG Research, October 2023

Xtrackers
by //DWS

Important Information: DWS is the brand name of DWS Group GmbH & Co. KGaA and its subsidiaries under which they do business. The DWS legal entities offering products or services are specified in the relevant documentation. DWS, through DWS Group GmbH & Co. KGaA, its affiliated companies and its officers and employees (collectively “DWS”) are communicating this document in good faith and on the following basis. This document is for information/discussion purposes only and does not constitute an offer, recommendation or solicitation to conclude a transaction and should not be treated as investment advice. This document is intended to be a marketing communication, not a financial analysis. Accordingly, it may not comply with legal obligations requiring the impartiality of financial analysis or prohibiting trading prior to the publication of a financial analysis. This document contains forward looking statements. Forward looking statements include, but are not limited to assumptions, estimates, projections, opinions, models and hypothetical performance analysis. No representation or warranty is made by DWS as to the reasonableness or completeness of such forward looking statements. Past performance is no guarantee of future results. The information contained in this document is obtained from sources believed to be reliable. DWS does not guarantee the accuracy, completeness or fairness of such information. All third party data is copyrighted by and proprietary to the provider. DWS has no obligation to update, modify or amend this document or to otherwise notify the recipient in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate. Investments are subject to various risks. Detailed information on risks is contained in the relevant offering documents. No liability for any error or omission is accepted by DWS. Opinions and estimates may be changed without notice and involve a number of assumptions which may not prove valid. DWS does not give taxation or legal advice. This document may not be reproduced or circulated without DWS’s written authority. This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, including the United States, where such distribution, publication, availability or use would be contrary to law or regulation or which would subject DWS to any registration or licensing requirement within such jurisdiction not currently met within such jurisdiction. Persons into whose possession this document may come are required to inform themselves of, and to observe, such restrictions. In Hong Kong, this document is issued by DWS Investments Hong Kong Limited. The content of this document has not been reviewed by the Securities and Futures Commission. © 2023 DWS Investments Hong Kong Limited. In Singapore, this document is issued by DWS Investments Singapore Limited. The content of this document has not been reviewed by the Monetary Authority of Singapore. © 2023 DWS Investments Singapore Limited. In Australia, this document is issued by DWS Investments Australia Limited (ABN: 52 074 597 401) [AFSL 499640]. The content of this document has not been reviewed by the Australian Securities and Investments Commission. © 2023 DWS Investments Australia Limited. © 2023 DWS International GmbH. As of 01/11/2023 CRC: 098443