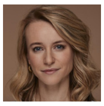
Addressing misconceptions with net-zero investing



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The journey towards achieving carbon neutrality, or net zero, by 2050 is not only essential for our planet but also increasingly demanded by investors. Motivations for those seeking to align their portfolios with net-zero often vary — spanning financial, societal, and ethical domains — yet many investors hold a common set of misconceptions related to implementation.

The beliefs that aligning with net-zero requires a high level of active risk, and that it is incompatible with active (factor) investing, are the two leading misconceptions held in the market today. Our latest research debunks these myths, demonstrating that investors can achieve alignment with their net-zero commitment without significant active risk and without compromising their return objectives.

Net Zero Doesn't Necessarily Require High Active Risk

The first of these misconceptions is the most deeply entrenched of the two. This is understandable given that many net-zero strategies exhibit high levels of tracking error. This issue is often due to sub-optimal portfolio construction. For example, many climate-focused indexes are substantially underweight in sectors such as energy and utilities. If sector volatility is high (for instance, due to sensitivity to economic events), the tracking error may also be elevated.

To demonstrate the misconception that a net-zero commitment requires significant active risk, we analyzed the impact of a carbon intensity reduction on a portfolio's active risk in the MSCI World Index universe. We calculated carbon intensity by dividing a company's carbon emissions by enterprise value including cash.

Our research shows that investors can achieve significant reductions in carbon intensity with very little active risk. Specifically, just 50 basis points (0.5%) of active risk in a portfolio is required to achieve an 80% reduction in carbon intensity. This scale of reduction is well ahead of the existing pathway for global carbon emission targets.

However, carbon intensity reduction is retrospective by nature, as it seeks to capture the impact companies are causing today as a result of their current operations and past decisions. Forward-looking measures of carbon risk, such as the MSCI Low Carbon Transition Score or the ISS Carbon Risk Rating, have a more material impact on active risk. For example, 100 basis points (1.0%) of active risk allows for a 17% improvement in the MSCI Low Carbon Transition Score and a 27% improvement in the ISS Carbon Risk Rating.

Putting it all together, we assess the impact of a representative set of net-zero criteria has relative to the MSCI World Index. These criteria include a variety of measures, such as companies achieving carbon emission reductions of 70% or more, and alignment with the United Nations' Sustainable Development Goals. We found it is possible to accommodate a robust set of net-zero policy requirements for only 50 basis points of predicted active risk, a level that many investors assume to be unattainable.

Carbon Reduction and Factor Investing Can Align

The second misconception is that investors cannot gain meaningful exposure to equity factors such as value in a net zero portfolio. On the contrary, our research shows that it's possible.

We find it is possible to maintain the vast majority of targeted factor content while achieving carbon intensity reduction levels above 70%. Integration of forward looking measures have a bigger impact on factor content, but investors can achieve portfolio improvements if implemented thoughtfully.

As with the previous misconception, we also applied our representative set of climate change criteria to the MSCI World Index to see how it would impact a multi-factor approach while allowing for up to 200 basis points of active risk. We found that it is possible to retain over 85% of factor content while meeting significant sustainability goals.

A Reality Check on Net Zero Investing

As the urgency to combat climate change intensifies, the momentum behind net-zero commitments increases. To date, this has caused significant qualms as to whether traditional investing models will allow investors to do so without losing sight of their approach, whether that is index-tracking or factor investing. We have shown that, while these challenges cannot be eliminated entirely, they are far from as insurmountable as many believe.

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