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HOW LOW CAN YOU GO?
INTRODUCING LOW-CARBON AND FOSSIL-FREE PASSIVE EQUITY OPTIONS

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WHAT LED TO THE EMERGENCE OF LOW-CARBON AND FOSSIL-FREE INDICES?

Mercer's recent study Investing in a Time of Climate Change[1] highlighted that investors should consider the risks posed by climate change — in particular, policy risks. Following the positive outcomes of the recent meeting of global leaders in Paris, where a new global agreement to manage carbon emissions and tackle climate change was reached, we anticipate that the policy response to managing climate change will become more urgent in the coming years.[2]

Some of the key financial risks associated with climate change are rising carbon prices and the potential for "stranded assets;" that is, the possibility that a proportion of existing fossil fuel reserves will never be utilized due to changes in regulation, demand, and technology.

In response, investors are increasingly considering how to hedge their portfolios against the risks posed by climate change, as well as seeking positive investment opportunities aligned with anticipated shifts in energy use and technology.

In a world where the cost of carbon is likely to rise, managing exposure to high-carbon companies is an intuitive step to take.

One approach investors can take is to reduce the carbon intensity of their portfolios over time, also known as "portfolio decarbonization." The benefits of this approach include:

- Creates a portfolio that is less susceptible to increasing carbon pricing, stranded assets, and/ or related regulation.
- Supports the flow of capital to a resilient low-carbon economy and may help address the market mispricing of carbon.
- Produces a market signal that incentivizes companies to develop and invest in low-carbon and clean technologies, influences policymakers, and also helps to catalyze a new standard for other institutional investors.

[1] Mercer. Investing in a Time of Climate Change, 2015, available at http://www.mercer.com/insights/focus/in-vest-in-climate-change-study-2015.html.

[2] Mercer. Dispatch from COP21: What the Paris Agreement Means for Investors, 2016, available at http://www.mercer.com/content/dam/mercer/attachments/global/investments/investing-in-a-time-of-climate-change-dispatch-from-cop21-mercer-2016.pdf.

WHAT ARE LOW-CARBON AND FOSSIL-FREE INDICES?

Low-carbon indices are designed to track broad market indices but with lower-carbon footprints, in some cases significantly lower.

The primary benefit of a low-carbon index is that it can be an important first step for investors to take to reduce the carbon intensity of their portfolios. Additional benefits include that they are relatively low cost (albeit typically a little more expensive than broad market indices), relatively simple to understand (that is, asset owners can point to a clear carbon reduction), and relatively easy to implement.

Allocating to a low-carbon index will be particularly relevant for those investors:

- With existing market-capitalization-weighted passive equity exposure.
- With an existing preference for passive management.
- Looking for a relatively low-cost solution to hedging carbon risk.

In a world where the cost of carbon is likely to rise, managing exposure to high-carbon companies is an intuitive step to take. However, investors need to consider carefully the methodologies and outcomes of these specialist indices:

- The indices are focused on risk management and do not capture the opportunity side of the equation (that is, by shifting from high-carbon to lower-carbon companies, investors may not necessarily gain exposure to companies leading on the development or provision of products/services best positioned to succeed in a lower-carbon environment).
- To date, the indices are typically based on a market-capitalization-weighted methodology, and therefore bring with them the same issues that such conventional market-cap benchmarks have in this context (for example, the lack of rebalancing means that investors end up with higher exposure to companies as their valuations peak relative to the market).
- Investors should be aware that although low-carbon indices are designed to track parent indices, the different construction approaches can lead to varying degrees of tracking error. During periods of extreme stress or market dislocation, the performance of low-carbon or fossil-free indices could deviate significantly from the mainstream benchmark index.
- Low-carbon indices remain subject to concerns around data availability and transparency. The reporting of carbon emissions remains relatively inconsistent (particularly in emerging markets) and hence data are subject to assumptions and sometimes opaque standardization methodologies.
- Current versions of low-carbon or fossil-fuel free indices do not include other screens, which may be important to some investors (such as tobacco).

OVERVIEW OF INDEX APPROACHES

Low-carbon indices and fossil-free investment solutions are a hot topic right now: multiple, competing indices have emerged over the last two years, with various investment vehicles launched. In our view, there are three broad categories of low-carbon indices: broad-market-optimized, best-in-class, and fossil-free. We have set out in the table below a summary of the likely investor suitability and appeal of the different approaches.

Approach	Example indices	Likely to be suitable for an investor that …
Broad-market-optimized	• MSCI Low Carbon Target • FTSE UK Carbon Optimised	**… does not have an exclusion policy in place.** – By starting with the full universe, the construction methodology is consistent with the way an investor with a focus on ESG integration applies its responsible investment approach more generally across its investments. **… is seeking reduction in the exposure to carbon emissions and to carbon reserves.** **… is seeking to reduce exposure to fossil-fuel-related carbon emissions.**
Best-in-class	• MSCI Low Carbon Leaders • S&P 500 Carbon Efficient Index	**… is able to accommodate negative exclusions.** – Typically such indices exclude the worst performers (in terms of carbon emissions/reserves) from each sector and re-weight across the sector. **… wants an approach that considers carbon efficiency across all sectors** (rather than focus on the sectors with the highest carbon emissions). **… wants to send a clear signal to stakeholders that the largest carbon emitters are not present in the portfolio.**
Fossil-free	• MSCI ex Fossil Fuel • MSCI ex Coal • FTSE ex Fossil Fuel • FTSE ex Coal	**… is able to accommodate negative exclusions.** – Typically more applicable to foundation/endowment investors. **… wants simple and transparent methology.** **… is committed to fossil-fuel divestment based on a full review of their investment beliefs.** – These indices may be appropriate as a benchmark for active management.

SUMMARISING MERCER'S VIEW

- The use of low-carbon or fossil-free indices is only one of the many tools available for tackling climate change risks. Low-carbon and fossil-free index strategies do not typically offer exposure to investment opportunities aligned with a shift to a low-carbon economy.
- These indices may not necessarily bring an outperformance premium in the traditional sense. The "premium" is reduced carbon exposure rather than performance. This reduced exposure may be rewarded in financial terms, all else equal, as policy measures develop to reward lower-carbon activities.
- Investors need to be fully aware of the underlying construction methodology — in particular, "fossil-fuel-free" does not have one consistent definition across asset owners, index providers, or investment managers.
- The use of such indices should not be seen as equivalent to, or as a substitute for, actively managed equities with a high level of ESG integration. Many actively managed strategies with strong ESG integration do not have exposure to high-carbon sectors as a result of their idea generation and portfolio construction process and are also able to capitalise on investment opportunities that specifically address climate change and low carbon.
- Low-carbon indices are expected to track (subject to tracking error limits) broad market indices with the potential for outperformance if policy measures develop to reward lower-carbon activities. We consider low-carbon indices to provide a scalable hedge against climate-change risk for passive investors, without necessarily forfeiting returns in the interim.
- Fossil-free indices are expected to show significant deviation from broad market indices. These indices may be appropriate for asset owners committed to divesting from fossil fuels and these indices may also be suitable as a benchmark for active management. Given their exclusionary nature, fossil-free indices have performed well in the recent environment of falling oil prices but would be expected to underperform if there was a reversal to the current trend.
- Both low-carbon and fossil-free indices can serve to meet external commitments to align with a decarbonizing economy and help to send a strong signal to stakeholders that they are proactively managing climate risk.

There are several questions for investors in determining the most appropriate approach, including:

- What risks do low-carbon/fossil-free indices protect against?
- Are there any unexpected consequences from the construction methodology?
- Could an investor be taking unexpected biases as a result?

Mercer has reviewed the indices provided by the leading index providers and has assessed a number of the current investment strategies available. This information is now available to support investor decision-making.

Contact your local Mercer consultant to discuss whether low-carbon indices are right for you.

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