

For institutional clients only.



Viewpoints

4Q 2021

Welcome to our latest Viewpoints, a quarterly publication presenting candid discussions with industry experts on vital topics. Should you seek additional information on this issue's subject, feel free to contact us. We welcome feedback as we shape content for future issues.

Presented by



Chris Wroblewski, CFA
Solutions Strategist
LGIM America



Alejandro Sepulveda
Strategy Associate
LGIM America

Featuring



Mark Wood, CFA
Senior Vice President
Callan



David Barron, CFA, CAIA
Head of US Index Solutions
LGIM America

Climate-risk and Its Implications on the Investment Industry

It's difficult to ignore the growing call to action to address the climate crisis, which some refer to as our generation's challenge. The scientific consensus continues to urge us to act, and more importantly, to act now. As investors, we frequently wonder why this risk is more important than others, what role do we have to play and how we should play it, and where do we draw the line between materiality and morality. These are the questions we will explore in our latest Viewpoints, as we discuss climate-risk and its implications on the investments industry with Mark Wood and David Barron.

Before we get started, we want to express our gratitude to Mark and David for volunteering their time and willingness to contribute to our quarterly Viewpoints publication. Each has considerable experience in the asset management sector and brings a distinct viewpoint to the table when it comes to asset management, ESG and client strategies. We are looking forward to a thought-provoking conversation.

Mark Wood, CFA, is a Senior Vice President and US Equity Asset Class Lead in Callan's Global Manager Research group. In his role, Mark drives the US market research, identifies emerging themes within the asset class and collaborates with Callan's Capital Markets Research team on manager structure best practices. Mark is a member of Callan's ESG team and Alternatives Review Committee. He is a shareholder of the firm.

David Barron, CFA, CAIA, is the Head of US Index Solutions at LGIM America. In his role, he helps grow the firm's footprint in ESG, factor and other index solutions. David joined LGIM America in 2015 as a Senior Portfolio Manager on the Index team. David then transitioned to work at LGIM as Head of Index Equity & Smart Beta where he led the Equity Index team with a focus on both traditional and smart beta index strategies. David returned to Chicago in late 2021 to take on his current role.



Let's start with you, Mark. How have you seen the relationship between climate change and investing evolve over the course of your career?

Mark: To paraphrase Ernest Hemingway in *The Sun Also Rises*, climate change became an important topic for investors gradually and then suddenly.

In the aftermath of the GFC, advancements in computing power (particularly cloud computing) prompted asset management firms to collect and quantify ever increasing volumes of data reported by government agencies and corporations. Asset managers gradually incorporated this data into risk and return models, which aided in the investment process. Simultaneously, institutional investors began examining risk parameters in their portfolio that aligned with the long-term risks and time horizon of climate change. Outside of the investment realm, the effects of climate change were becoming more evident and more frequently reported. The tipping point was the United Nations conference on climate change (COP 21) in Paris in 2015, where targets were set to reduce CO2 emissions globally in order to meet temperature increase thresholds by specific dates.

Following COP 21 in 2015, a reflexive cycle began where asset managers more readily incorporated climate data and models into their processes in order to assist asset owners in reducing carbon exposures as they became increasingly interested in measuring carbon emissions and potential climate risk in their portfolios. This led to increased demand for asset manager climate risk analysis, which in turn led to increased asset owner interest in climate change impact scenario analysis and measurement for their portfolios.

Suddenly, in 2021, a number of prominent college endowments and large public pension fund asset owners announced divestment and de-carbonization (carbon net-zero) plans to meet specific target dates. Many of these announcements preceded the

November 2021 COP 26 meetings in Glasgow, Scotland.

The gradual then sudden characterization is an apt way to view recent developments in the climate change and investing conversation. So, Dave, building on that narrative, how have you seen the relationship between climate change and investment management evolve, starting with COP 21 as the tipping point, as Mark mentioned?

Dave: In the last five years, the relationship has evolved from ice cold to one of the most critical long-term considerations in the industry, with the growth in interest at near hyperbolic rates (especially in Europe). The shift has been influenced by numerous forces and was undoubtedly accelerated following the 2015 Paris accord, with mainland Europe dominating early adoption. The UK soon followed suit, with growth accelerating three or so years ago.

Local regulation helped to drive up demand for climate integrated solutions and considerations by deeming ESG and climate factors as financially relevant and requiring consideration of them in investment policy statements. Regardless of the catalyst, in all instances, the initial conversations on the topic were all about educating the asset owning community, and in many cases ourselves, on the importance of incorporating climate considerations into investing. We had to answer the why, what, how and the why not questions.

Naturally, this leaves me intrigued as to what the next chapter has in store for us. Where do you see us heading next?

Dave: You may have noticed that I was silent on the US adoption story in the last response, and this was intentional. The US level of education on the subject, as well as the solutions available, are still in their early stages compared to Europe. So, a natural expectation is for the trend to accelerate in the US, although at a slightly slower

pace given regulation hasn't been as accommodating or consistent in the last 4-5 years. That said, we are already seeing more than a trickle in the dam holding back a tidal wave of requests for ESG and climate integrated solutions from US institutional clients.

One of the major educational catalysts for adoption is emphasizing the simple, but often misunderstood, fact that an ESG or climate portfolio does not have to be ex-Fossil Fuel investments, or even underweight energy. Many strategies do exhibit those characteristics, but that is not the only way to build a portfolio that attempts to harness the risks and opportunities of a transition. That is the advantage of utilizing forward looking metrics and increased disclosure from corporations regarding climate policies and plans. Point in time laggards on climate today may in fact lead the transition tomorrow. Over the next decade, we will become more adept at identifying the true leaders and laggards, and we will hopefully see some of the transition trends take off.

Where do you see this going in the next decade for the institutional community?

Mark: Today, the interest amongst the Callan client base is not uniformly distributed by type or by size. For instance, mega sized public defined benefit (DB) plans have the resources and asset pools to develop customized solutions and face a high-level of public scrutiny whereas their smaller sized peer plans are generally in an educational phase. We see some similar dynamics about endowments and foundations by size of fund. Meanwhile, corporate defined benefit and defined contribution clients continue to wait broadly for more guidance from the Department of Labor.

Looking forward, Callan data suggests that interest and education will increase across fund types. The data also suggest a bias towards action for public DB plans and endowment and foundations with sizable asset pools and resources to implement and monitor customized climate solutions.

For asset managers, our expectation is for increased measurement of CO2 emissions within portfolios and more coordinated efforts to drive change via engagement or exercising shareholder voting. In addition, Callan anticipates growth in strategies providing specific net zero glide paths and time horizons.

With that context, it's easy to see why ESG, particularly ESG's environmental considerations, have become focal points in many investment conversations. Why would someone want to align their investments to net zero or reduce their carbon/fossil fuel exposure?

Dave: First, let's get the moral and more social reasons out of the way. Supporting a transition to a low carbon economy is seen as a "good" thing. Preserving forests, wildlife habitats and coastal landscapes does not seem too terrible an endeavor. From a financial perspective, we see three main scenarios for the world going forward: 1) business as usual, resulting in significant warming and physical risk, 2) an orderly transition to net zero by 2050, and 3) a disorderly scenario.

Our transition risk is created by the orderly and disorderly transitions, with the disorderly transition aptly named because it is more disruptive to people and corporations than the orderly transition. An investment strategy that aligns to a net zero objective or seeks to intelligently reduce exposure to carbon or fossil fuels is looking to take advantage of the opportunities and risks these potential trajectories will produce.

I mentioned it briefly before, but a net zero aligned or carbon emission reduced strategy does not have to bet the farm against big oil today. This is meant to be a transition, so the steps we take in 2022 could be small in comparison to where we hope to be in 2049, but directionally supportive of a transition. This is where asset allocators, stewards of capital, policy makers and individuals can help steer a preference towards our future energy mix. A perhaps too

oversimplified account of economics and investing is it is the capital providers who get to determine value, which makes climate investing a potentially self-fulfilling prophecy. If investors value our high emitter on a good path, company A, more than company B, this should be reflected in the relative price of the securities, and as a result, impact performance. Of course, the opposite could be true, but the point is that if everyone in the future drives electric vehicles because they do everything a combustion engine can but with zero emissions, we'd have a pretty good idea of what a combustion-engine-only car manufacturer's value would be.

There is certainly an investment case that can be built around the transition's risks and opportunities, but Mark, how would you describe the relationship between fiduciary responsibility and climate considerations?

Mark: Callan has noticed a shift in thinking regarding the relationship between fiduciary duty and climate considerations. The growth in portfolio analytics and the inclusion of a "climate risk premium" in asset allocation analysis will lead asset owners to consider plan risks holistically, in accordance with their fiduciary duties. Climate risk is one component of this evolving fiduciary mindset, which also includes cybersecurity and other non-financial considerations.

Based on your observations, how effective are the available strategies for getting us to where we want to go in terms of climate change goals?

Mark: For investors, clarifying goals is paramount to measuring effectiveness. Is the goal to reduce carbon in the portfolio or in the real world? Divesting from high carbon emitting companies in a public equity strategy will lower the carbon measured at the portfolio level but has no real-world impact on total carbon emissions beyond given the availability of the next marginal buyer. Conversely, investing in a high carbon emitting company with

“For asset managers, our expectation is for increased measurement of CO2 emissions within portfolios and more coordinated efforts to drive change via voting.”

**Mark Wood, CFA
Callan**

the goal of engaging with the board or management to transition the company's business model away from carbon would increase the measured level of carbon in the portfolio, but may result in lower carbon emissions in aggregate going forward.

Today, at the industry level, we are in the early stages of product design, development and measurement, making it difficult to draw broad conclusions about industry-wide efficacy. Today's investment strategies are generally split into two camps with similar but distinct goals: 1) carbon mitigation, 2) benefitting from transition to a green economy, or 3) combination of the two. Carbon-reduction strategies can be measured against a market cap weighted benchmark using more accessible Scope 1 and Scope 2 emissions data. Strategies seeking to benefit from the transition to a green economy, on the other hand, are typically actively managed and rely on the judgement of the underlying investment manager to identify opportunities to unlock potential alpha.

Mark alluded to real-world impact. This is truly fundamental to the collateral

benefits climate solutions can provide. Can you explore the importance of these investments having real-world outcomes and if they can be tracked or measured?

Dave: True. Being able to answer questions regarding opportunity costs of the decision to move to this type of investing is paramount. It should be reviewed, re-visited and understood throughout the life of the investment. There are two outcomes we should be tracking. First, is the stewardship perspective. The intent with climate investing does not have to be, and some argue that it should not be, limited to profiting from risk and opportunity in the physical and transition risk scenarios that face global economies.

The other opportunity is to influence corporate behavior and intent through engagement and shifting of capital. There is a not too utopian of a goal that our present day 3°C high emitting equity universe naturally decarbonizes to net zero by 2050 and we can shut all of the climate strategies down because our common equity benchmarks (S&P 500, MSCI World, etc.) are all net zero without any intervention. Bringing that thought back down to earth, we can, and should, track progress of our engagement efforts. Are we seeing change? Are laggards becoming leaders? At LGIM America, our Climate Impact Pledge is one such focused engagement effort that quantitatively and qualitatively pushes for and tracks progress. We have seen some significant strides in companies who are looking to take advantage of the opportunity ([view our Climate Impact Pledge](#)).

The other piece of the puzzle that must be measured is the financial impact of starving capital from laggards and giving it to the leaders. The active risk or share is a real financial risk and the cost/benefit can be measured by comparing an unencumbered benchmark (e.g. S&P 500, MSCI World, etc.) to the performance of the climate integrated strategy. I would caution against overreliance on back-tests and short-termism here though. There is not

a lot of reliable history in climate metrics and the push for the transition is still fairly new.

That provides an excellent starting point for addressing what some may regard as the elephant in the room. Concerns have been raised about the risk/return viability of these strategies. Does performance suffer in the face of pursuing climate goals? And to what extent do you think sub-par performance would affect adoption?

Mark: Providing appropriate context and managing expectations are paramount when investing in climate strategies. Confirmation bias is a huge determinant of how strategy performance is viewed by asset owners - those pre-disposed to believe it will outperform will find evidence to support the view (and vice versa). Adding to the complexity, track records for live strategies beyond five years are rare. Thus, healthy skepticism on the part of asset owners is part of their fiduciary duty to their funds. Evaluating performance across risk-adjusted returns is also critical, as a key role for climate strategies is to mitigate risk exposure to particular industries and exposures. Finally, asset owners must make the distinction between the goals of different approaches. For example, negative screening to minimize carbon is typically implemented with an index approach with the goal of minimizing tracking error relative to the policy cap-weighted benchmark. Conversely, actively managed climate strategies have the goal of outperforming a market-cap weighted benchmark.

Dave: One of the key aspects of this space is the idea that clients can choose, based on investment beliefs, the level of desired impact and opportunity cost, or capital they'd like to risk and find a compatible strategy. Investors can determine their desired ESG focused portfolio based on objectives that may take modest amounts (e.g. 15, 30, 50 bps) of tracking error away from a standard benchmark to drive their climate objectives. Alternatively, the

investor can target something more high octane that seeks to shift capital away from perceived laggards. Sustainable outcome-oriented strategies are available that are enhancements on specific allocations to sectors or factors. For example, minimum volatility strategies often favor utilities in order to achieve the reduced volatility objective. However, utilities are in a high impact sector with respect to a transition to a low carbon economy, so getting specific with which utilities are driving your minimum volatility exposure may just limit potential future shocks should a transition occur. Investors should look for demonstrated results on an investments portfolio level risk profile when compared to one that does not take climate into account at all.

To broaden the scope of this discussion, what are the ultimate headwinds for climate-focused investment strategies?

Mark: Regulatory uncertainty remains a consistent headwind for broad adoption of climate focused strategies amongst institutional clients. Asset owners want to ensure they are fulfilling their fiduciary duties while also avoiding running afoul of potential legislation that may change with new administrations. Additionally, aligning the time horizon of climate investing (i.e. long and/or perpetuity) with the much shorter time horizon used for performance measurement (e.g. monthly reporting, quarterly meetings, and three- and five-year trailing periods considered "long-term") are headwinds to successful long-term engagements. Further, the tenure of Board Members and Trustees may not align with the long-term goals of climate investing (e.g. prior board members enact allocation to climate strategies that new board members do not agree with and may change).

Given the variety of ways in which people approach and interpret climate risks, what level of flexibility do managers have in assisting clients in expressing their views in the products in which they invest? Is investing in climate-friendly strategies a more prescriptive exercise or customizable one?

Dave: I'm hoping the answer is limitless. More specifically, limitless amounts of flexibility, and it is certainly something we're exploring as an asset manager and solutions provider. How can we responsibly scale the required customization to meet investor demand without losing sight of the overall objective of this type of investing is a key challenge of the industry. When we find like-minded investors, we can certainly benefit from pooling because the voice of many is stronger than the voice of one. However, in order to help break down the headwind surrounding adoption and cast the stone that breaks down the dam holding back the flood of demand, we have to acknowledge that asset owners perceive risk and opportunity differently. So, we must accommodate those differences through customized climate solutions to spur the adoption and help effect change.

With all the global attention on climate change seeping into the world of capital markets, and after all the perspectives both Dave and yourself have shared on this topic, I'd like to offer the final word to you Mark. What is one piece of advice you'd give to an asset owner (and/or manager) on this climate journey we're all about to embark on?

Mark: Callan advises our clients to be methodical when making large plan level decisions. We have observed the most success at implementing new ideas when asset owners socialize an idea internally to staff, board members and trustees, and build a set of shared values and collaborative buy-in, prior to the final decision being made. As such, educating and framing the discussion properly are paramount to long-term success. ■

About LGIM America

LGIM America (LGIMA) was founded in 2006 with the purpose of helping people achieve their long-term financial goals. We offer a range of strategies to help our institutional clients (corporations, healthcare agencies, non-profit, education, public plans and Taft-Hartley) manage their investment objectives, which can range from market-based alpha-oriented strategies to those that are designed to be more liability-centric, derivative overlays, or indexed solutions. Encouraging a diverse and inclusive environment coupled with a solutions-focused culture allows us to increase our breadth of knowledge and the likelihood of improved client outcomes and stronger financial performance. We have teams of experienced, innovative professionals committed to helping plan sponsors meet their pension promises, managing investment exposures efficiently to seek enhanced returns while mitigating risks, and working to generate returns while making a positive societal difference. As of September 30, 2021, LGIM America had \$262 billion in assets under management.

For further information about LGIM America, find us at www.lgima.com

IMPORTANT INFORMATION

This material is intended to provide only general educational information and market commentary. Views and opinions expressed herein are as of January 2022 and may change based on market and other conditions. The material contained here is confidential and intended for the person to whom it has been delivered and may not be reproduced or distributed. The material is for informational purposes only and is not intended as a solicitation to buy or sell any securities or other financial instrument or to provide any investment advice or service. Legal & General Investment Management America, Inc. does not guarantee the timeliness, sequence, accuracy or completeness of information included. Past performance should not be taken as an indication or guarantee of future performance and no representation, express or implied, is made regarding future performance.

