UNDER THE SPOTLIGHT:

Climate change ETFs two years on

Climate ETFs: Emissions, impact and ESG

Rumi Mahmood, ESG fund research, MSCI

Climate change ETFs: A temperature check

Tom Eckett, Editor, ETF Stream

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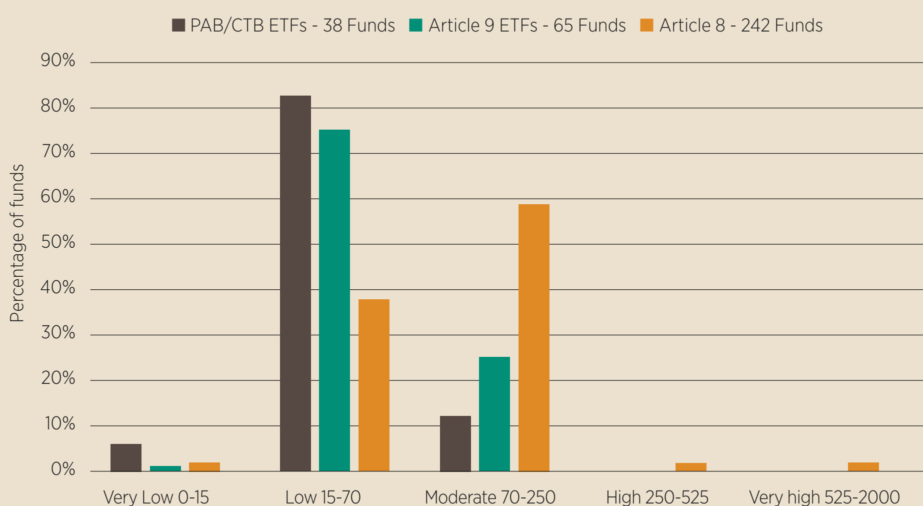
Climate ETFs: Emissions, impact and ESG

The universe of ESG ETFs is ever expanding. With an estimated total of over 400 ESG ETFs globally, the rise and adoption of these products reflect a paradigm shift in global attitudes across market participants and a growing recognition that ESG factors are financially material, transcending beyond security selection to fund level application as well

By Rumi Mahmood

Climate-focused ETFs are among the most recent additions to this product universe. Currently these funds number in the handful, at just under 40 ETFs globally, all domiciled in Europe with assets under management of just under $10bn, or approximately 4% of overall ESG ETF assets. These ETFs aim to help investors who are seeking to mitigate climate transition and physical risks, while also capturing novel investment opportunities. Some go further towards supporting the decarbonisation of the economy while being aligned with the Paris Agreement, incorporating recommendations of the Task Force on Climate Related Financial Disclosures (TCFD). But do these funds walk the walk and provide a measurable uplift in ESG attributes relative to their peers?



Source: MSCI ESG Research and Refinitiv/Lipper, as of 10 October 2021

Emissions

Carbon emissions are one of the most salient metrics when it comes to ESG ETF scrutiny. The EU's mandated SFDR classifications have helped to improve the quality of disclosures in ESG ETFs and add a degree of standardisation across the universe of funds, therefore enabling more informed fund selection. Taking this group of SFDR certified ESG ETFs and comparing them on carbon intensity, we find that going from Article 8 to Article 9 to specifically those ETFs tracking Paris Aligned (PAB) and Climate Transition benchmarks (CTB), there is a clear shift downwards towards lower weighted average carbon intensities at the fund level.

In fact, the PAB/CTB ETFs on average are 30% less carbon intensive relative to Article 9 funds, and 60% less carbon intensive relative to Article 8 funds. It is worth noting that as well as an absolute reduction in emissions intensity relative to peers, a number of these ETFs also have forward-looking ongoing self-decarbonisation rates designed to align with a 1.5°C scenario, meaning that over time the intensity difference is expected to become greater.

Impact and solutions

Looking deeper at solutions and impact, there was an upwards shift in both moving from Article 8 to 9 to PAB/CTB ETFs. Sustainable impact metrics can help investors measure fund exposure to com-

panies addressing core environmental and social challenges. These are relevant to impact-based investors with a preference to capture measurable social returns per dollar invested across goods and services including clean technology, community building, or access to healthcare. The average PAB/CTB ETF exhibits a portfolio weighted revenue exposure to sustainable impact solutions of 33%, versus 17% and 10% for Article 9 and 8 ETFs, respectively.

Focusing on carbon-specific solutions, specifically the percentage of portfolio's market value with a low carbon transition category of solutions, a similar pattern is observed. ETFs with above 40% exposure to low carbon transition solutions predominantly lie in the PAB/CTB category driven partly through index rules that shift the weight of constituents from brown to green activities, in particular optimised exposure to companies providing clean technology solutions.

Overall ESG ratings

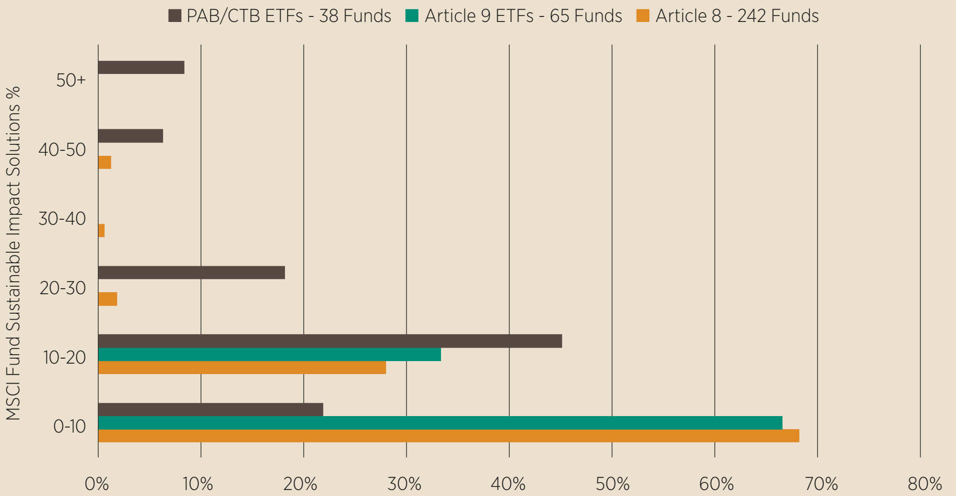
Finally, we look at the overall resiliency of the ETFs to long-term ESG risks and opportunities measured through the MSCI Fund ESG Rating. This also considers the holdings' ESG rating trend and the funds' exposure to holdings that are improving and worsening in this regard. As expected, all ETFs in these groups perform strongly, largely falling in the A-AAA categories. The PAB/CTB ETFs however predominantly fall a notch higher within AA-AAA, compared to the Article 8 and 9 funds which are relatively more dispersed.

Perhaps all this is not surprising. After all, this is as would be expected when following these ETFs through their SFDR classifications to darker shades of green. And while such distributions can pose challenging fund selection questions – should I invest in article 8, 9 or Paris Aligned ETFs? – the findings validate that these funds, despite the breadth of choice they offer, on average show a marked improvement trajectory.

Index-based ESG strategies as they stand offer investors with optionality. It is important to recognise that different investors are at different stages in considering sustainability, therefore providing choice is important, to educate, influence and gradually steward the market in a manner such that one day sustainability considerations, are not a matter of choice, but effectively the market norm. That status quo shift takes time and climate ETFs are a necessary addition to the investor toolkit in driving that change by taking into consideration more ambitious decarbonisation objectives.

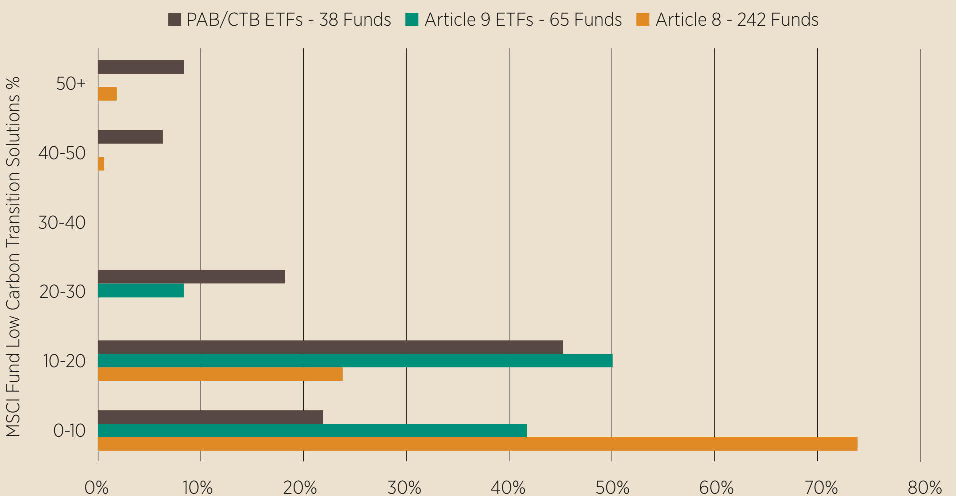
Rumi Mahmood leads ESG fund research at MSCI

CHART 2: REVENUE EXPOSURE TO SUSTAINABLE IMPACT SOLUTIONS



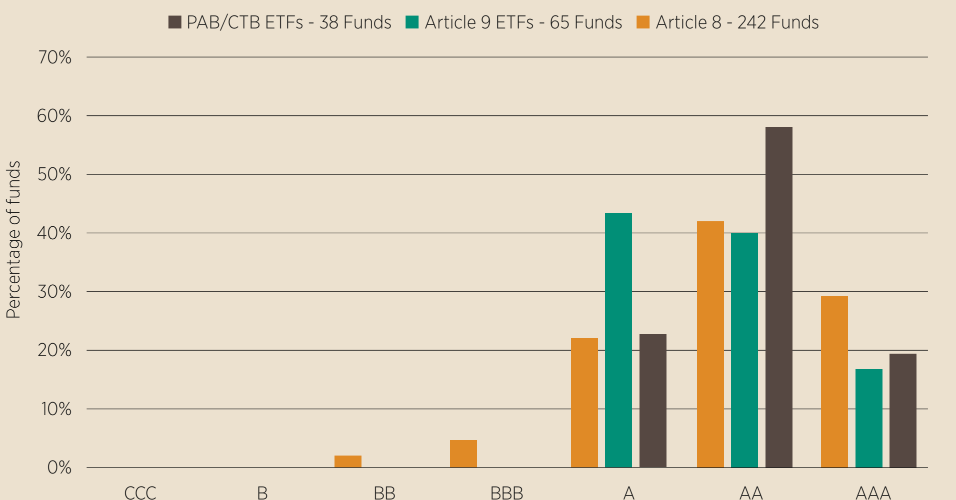
Source: MSCI ESG Research and Refinitiv/Lipper, as of 10 October 2021

CHART 3: PERCENTAGE EXPOSURE TO LOW CARBON TRANSITION SOLUTIONS



Source: MSCI ESG Research and Refinitiv/Lipper, as of 10 October 2021

CHART 4: OVERALL MSCI ESG RATING OF CLIMATE, ARTICLE 8 AND 9 ETFS



Source: MSCI ESG Research and Refinitiv/Lipper, as of 10 October 2021

Climate ETFs: A temperature check

The first ETFs tracking the European Union's climate benchmarks were launched to much excitement in March 2020, however, the product set has seen some negative press in recent months amid claims of greenwashing. Has this criticism been justified?

By Tom Eckett

Climate exchange-traded funds (ETFs) have come under fire in recent months amid claims they overstate their virtues while doing little to incentivise emissions reduction across the global economy, however, are these warnings going too far in their analysis of the latest product set to hit the European ETF market?

The sector has quietly been gathering pace since the first climate ETF came to market in March 2020 via French asset manager Lyxor. According to data from MSCI, there are now 38 climate ETFs listed in Europe with just under $10bn assets under management (AUM).

However, while investors have slowly started to gain exposure to these strategies, there has been a growing number of critics voicing their concerns about the product-set. The most notable critique came in September this year when EDHEC Business School released a paper warning about greenwashing risks in the construction of climate ETFs.

The research, titled *Doing Good or Feeling Good? Detecting Greenwashing in Climate Investing*, found climate strategies were allocating heavily to companies with deteriorating climate performance than those with a key role in decarbonising the economy. In particular, the research said climate scores represent "at most" 12% of the determinants of constituent weightings within climate ETFs.

The report argued: "We suggest that when climate considerations represent less than 50% of the determinants of the weight of the stocks in a portfolio that is presented as promoting the transition to a low carbon or net-zero economy, then this portfolio should be considered to be at a significant risk of greenwashing and should not be permitted to claim that it is climate-friendly or aligned with net-zero ambitions."

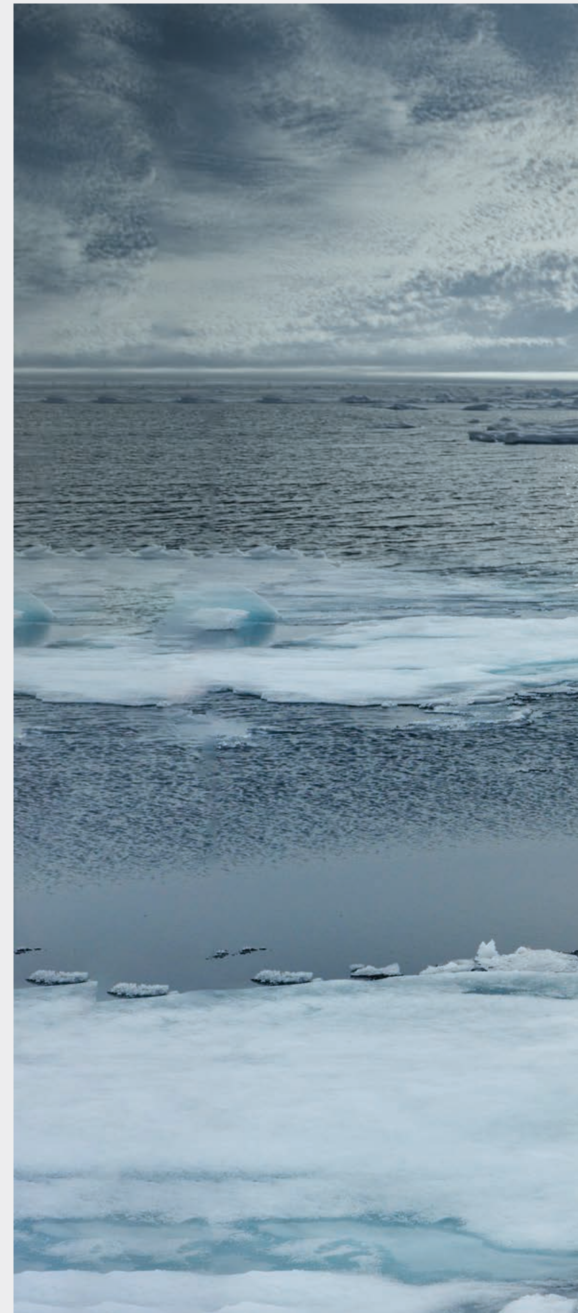
Furthermore, research conducted by think-tank InfluenceMap found 71% of equity ESG funds – including climate ETFs – scored negatively on Paris Alignment suggesting their portfolios were contrary to global climate targets.

These volleys come a year or so after index provider Scientific Beta – which is yet to launch any of its own climate indices – claimed there are "significant flaws" in the European Union's two climate benchmarks – the Paris Aligned (PAB) and the Climate Transition (CTB) – including the incorporation of Scope 3 emissions in some index methodologies.

Carbon emissions

However, the debate is more nuanced than simply climate ETFs are driving greenwashing. As part of the Paris Agreement, countries have pledged to reduce greenhouse gas emissions by at least 40% by 2030 in order to mitigate the risks of climate change. As a result, measuring the carbon intensity of a fund can be one way to determine its sustainable impact.

According to data from MSCI, climate ETFs tracking PAB or CTB are on average 30% less carbon intensive relative to funds labelled Article 9 under the Sustainable Finance Disclosures Regulation (SFDR) and 60% less carbon intensive relative to Article 8 funds. Furthermore, in order to ensure the transition to a low carbon economy, the indices employ a forward-looking decarbonisation reduction of 7% a year. This means the difference between climate ETFs and Article 8 or 9 strategies will become wider from a decarbonisation perspective.



BENCHMARK OBJECTIVES

The four main objectives of the European Union's climate benchmarks:

- Allow a significant level of comparability of climate benchmarks methodologies while leaving benchmarks' administrators with an important level of flexibility in designing their methodologies
- Provide investors with an appropriate tool that is aligned with their investment strategy
- Increase transparency on investors' impact, specifically with regard to climate change and the energy transition
- Disincentivise greenwashing

Rumi Mahmood, ESG fund researcher at MSCI, says it is important to understand climate conscious investors are not one group with homogenous views as there is not yet a globally agreed market standard on what it means to be a climate investor. "If anything, they are a spectrum, with preferences and mandates in different shades of green," Mahmood continues. "Some care more about avoiding high emitting sectors right now, whereas others care more about being invested in those with the most transitioning momentum. This spectrum is reflected in the universe climate funds.

"We have to recognise that different investors are at different stages, and providing choice is important, to educate, influence and gradually steward the market in a manner such that one day sustainability and climate considerations, are not a matter of choice, but effectively the market norm. That status quo shift takes time. Clients preferring different shades of green is not greenwashing," Mahmood concludes.

"We have to recognise that different investors are at different stages, and providing choice is important, to educate, influence and gradually steward the market in a manner such that one day sustainability and climate considerations, are not a matter of choice, but effectively the market norm"

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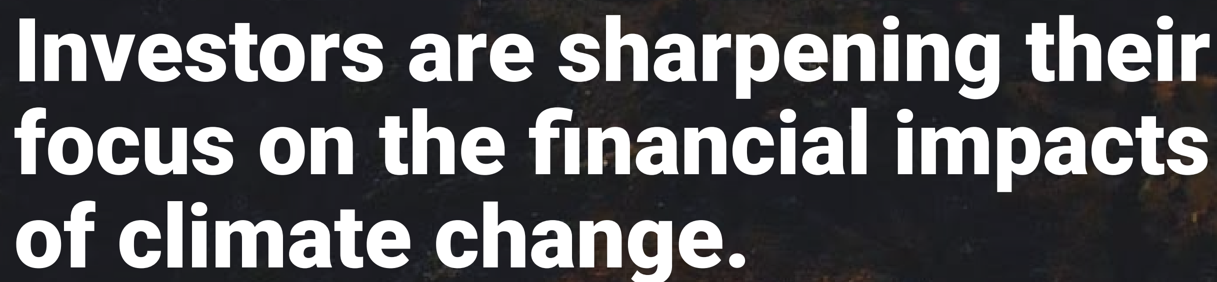

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