Allspring

In Conversation With ... Allspring Systematic Edge

With the UN COP 26[1] Climate Change Conference behind us and a slew of net-zero corporate pledges continuing to roll in, companies will be increasingly affected by, and participating in, the low-carbon transition of the global economy. This decarbonization pathway for the real economy means that climate change has become a consistent and urgent area of focus for investors. Against this backdrop, Himani Phadke, Jonathan Cangalosi, and Peter Weidner discussed the implications of 1.5- and 2.0-degree alignment in global equities portfolios.

HIMANI: With the daily news feeds highlighting the personal suffering and significant economic costs across the globe resulting from climate change, could you explain why the team chose to design climate portfolios and how you leverage your *quantamental* approach to focus on the issue of climate change?

PETER: For all of the reasons you just mentioned, we wanted to launch a portfolio that would make it easy for asset owners to invest in the transition to a decarbonized economy. By offering a portfolio that invests only in companies identified as on track for a 2-degree or better climate outcome, we offer a transparent option for investors who want to invest in companies that are well positioned for this transition. Our quantamental investment approach targets companies that are attractive through a climate lens and also have the potential to outperform. By managing risk against broad benchmarks, we provide this transparency and outperformance potential in a format that fits easily into investors' asset allocations.

Quantamental is all about aiming to blend the best of quantitative tools and fundamental analysis. Quantitative tools help us cast a wide net to objectively identify investible companies and assess their attractiveness. The fundamental analysis helps us dig deeper to understand the less quantifiable information. By combining both sets of results, we can build a holistic view of a company.

This blended approach is well suited for incorporating different types of data that provide different information about companies. In this case, the approach allows us to consider a company's financial attractiveness as well as its targeted alignment toward decarbonization.

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1. COP26 refers to the UN Climate Change Conference of the Parties, for which Glasgow in the U.K. hosted the 26th meeting in November 2021.

HIMANI: Could you discuss the origin of the *2 degree global equity* portfolio, and how you think it could contribute to altering the current emissions trajectory in a positive manner?

JON: The portfolio's origin lies in the desire to deliver outcome-focused investments. In this case, we wanted not just to focus on current levels of emissions, but companies' trajectories and the climate outcomes they implied. Alignment with the Paris Agreement's goal of limiting global temperature increases to 2 degrees Celsius or lower provided us a way to transparently link the portfolio to an outcome, which was very exciting for us.

As investors continue to make pledges about transition, we aim to make it easy for them to invest in a decarbonized future. We're therefore building a portfolio that represents companies well positioned for the transition to a decarbonized version of the full economy. This is a portfolio that fits well into an asset allocation and provides investors with the potential for outperformance. Our goal is to help investors on the journey of decarbonizing their portfolios in an effort to limit climate change to well below 2 degrees Celsius.

HIMANI: It's quite compelling that all companies in the portfolio have been identified to be aligned with a 2-degree Celsius or better outcome. What does that mean in practice, and what is its significance?

PETER: Alignment means more than just looking at the current state. It's about adding a forward-looking lens to identify companies' trajectories. We use S&P Global Trucost, an industry leader in carbon emissions data, as our primary data source for this analysis. The data help us assess companies based on both forward-looking lenses that incorporate targets and emissions trajectories and current-state lenses that look at their emissions now. We supplement this with a fundamental review of each company.

An example of such a company is CSX Corporation, an international transportation company offering a variety of rail, container-shipping, intermodal, trucking, and contract logistics services. The company is actively reducing its carbon footprint and implementing fuel efficiency initiatives. While CSX's current performance on carbon and environmental, social, and governance (ESG) metrics is better than the benchmark, this is a good example of how the 2-degree global equity portfolio acknowledges that a transition to a decarbonized economy does not happen overnight and that, as an economy, we still require services that companies like CSX provide. However, CSX and all other potential candidates for the portfolio must be 2-degree aligned and highly ranked across our quantitative model for inclusion in the portfolio.

> "Climate change threatens our way of life. It is only by acknowledging this fact that collectively, as a global society, we can enact change."

HIMANI: Are there additional sustainability features captured in the design of this portfolio besides the focus on climate?

JON: We understand that climate is just one dimension of sustainability and that while climate is the primary focus of this portfolio, it's also important to consider other dimensions. We consider ESG characteristics more broadly and environmental characteristics beyond climate in order to avoid industry laggards. In addition, we exclude companies involved in controversial business practices, such as manufacturing tobacco or controversial weapons.

HIMANI: How can investors think about such climate-oriented equity portfolios within the context of standard indexes and investors' risk, return, and impact objectives?

JON: We've designed the portfolio to fit into investors' existing asset allocation models and processes. This is one of the main reasons we chose to benchmark against a broad-based index, which we believe is the most relevant for investors.

There are other reasons for choosing a standard index. It allows us to have greater control of the portfolio's composition rather than a style or climate index with embedded biases. We believe that with the transition to a lower-emissions economy, benchmarks will naturally gravitate in this direction. Crucially, the transition to a decarbonized economy will evolve over time but will still have the same elements—such as power generation, transportation, and manufacturing—that are needed today. We want to invest in cleaner versions of each element of the economy rather than avoid certain elements in their entirety. By using this approach, the portfolio, in our view, should fit nicely in an overall broad-market allocation and simultaneously help investors achieve their sustainability targets.

Named companies are for illustrative purposes only and not a recommendation to trade.

HIMANI: How do you think about climate risk in that context?

PETER: Whether the global temperature remains on its current trajectory or decreases per the objectives of the Paris Agreement to 2 degrees Celsius or better, climate change risks are unavoidable and therefore need to be managed. These include both physical risks, such as from the impacts of flooding, wildfires, and record-setting heat waves, and transition risks, such as those arising from technological changes that lead to stranded assets, carbon taxes, and regulatory changes. The actual path is likely to be a combination of those scenarios, with some level of physical risk and transition risk.

JON: Why is this important? The simple answer is that risk may hide for a while, but it takes different shapes and never really goes away. Therefore, a robust risk management approach is paramount. We evaluate risk from multiple dimensions by taking a top-down macro and bottom-up fundamental perspective using both quantitative tools and fundamental analysis. It's our belief that a holistic approach using multiple lenses will benefit our investors as the global economy transitions to a decarbonized one.

HIMANI: When you consider actions on climate change, what are some things that excite you as we look further into 2022?

PETER: What excites us is the level of attention and action that the efforts to achieve net-zero emissions are receiving. The sad reality is that after excluding controversial holdings and the worst ESG offenders from our universe, only about 25% of companies remaining in the universe are on track for a 2-degree or better outcome, according to our latest reading of S&P Trucost's climate alignment data. Many of those results are due to the industries the companies are in rather than to their deliberate efforts to make progress.

However, we see reasons to hope that this situation will change quickly. The world is increasingly paying attention to climate change. It's happening on personal, political, and corporate levels. Commitments are increasingly being made by corporations to make meaningful emissions cuts to strive to achieve net zero. These commitments will need to be followed by action, and as this occurs, it will create more opportunities to invest in alignment with a decarbonized future. We're excited to be part of it!

> "Decarbonization is a process that balances the needs of today with the necessities of tomorrow."

2-DEGREE GLOBAL EQUITY APPROACH

Goals-based approach: Investing only in companies that have been identified as on track for a 2-degree-or-better climate outcome and aiming to achieve at least a 50% reduction in carbon intensity and carbon footprint, a better energy mix, and reduced reserve emissions relative to the benchmark[2]

Active stock selection: Leveraging the best in quantitative tools and fundamental insight

Multi-dimensional risk management: Holistic approach to managing fundamental, macro, and proprietary risk exposures

Additional sustainability targets: Exclude companies with controversial business practices and avoid companies having an overall ESG rating below BB (per MSCI's ESG ratings)[3]

2. While the portfolio management team attempts to maintain the 50% carbon intensity and carbon footprint reductions, better energy mix, and reduced reserve emissions relative to the benchmark at all times, these are targets rather than binding characteristics of the portfolio. The portfolio may not meet all of these targets at all times.

3. While the portfolio management team aims to avoid companies rated below BB by MSCI at all times, this is not a binding characteristic of the portfolio, and is not currently monitored systematically due to internal system limitations.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

Contact details

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