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Following the rules

How alternative beta can help support a more sustainable world

Following the rules: How alternative beta can help support a more sustainable world

Many investors are now considering rules-based and index-like investment strategies in order to help achieve non-financial – i.e., environmental, social and governance (ESG) – goals. Rodrigo Dupleich explains the different approaches available to investors, as well as the pros and cons of implementing each of them.

The trend towards ESG and sustainability has been driven, in large part, by investors' prioritization and customization of ESG concerns, regulatory frameworks (e.g., the Sustainable Finance Disclosure Regulation (SFDR)), and improvements in data quality and availability. And all this has helped pave the way for rules-based – or index-like – sustainable investing. Such strategies can provide flexible, customizable portfolio solutions that can help meet the range of climate and sustainability solutions.

Rules-based strategies can offer multi-faceted, climate-aware approaches that incorporate broader ESG considerations, such as human rights issues, biodiversity, diversity and equity in employment and inequitable social structures. Or customization of a sustainable/climate-aware strategies can allow investment managers to also incorporate risk premia that focus on well-known factors such as growth or value, or quality. Rules-based approaches could also take core climate portfolios a step further, incorporating rules that seek to help asset owners to achieve their net-zero ambitions through their investments.

Ultimately, there are three particular areas where we see strong demand for rules-based strategies:

- Combining sustainable managed strategies with risk premia strategies
- Climate strategies considering social aspects, in the context of 'just and fair' transitions or the UN Sustainable Development Goals (SDGs)
- Net-zero strategies

Combining sustainable managed strategies with risk premia strategies

Given the current market environment, clients are paying increasing attention to harvesting well-known risk premia while aiming to make their portfolio aware of sustainable issues. For example, valuation-based strategies may have benefits in a global inflationary environment, while quality and low volatility strategies tend to be appealing in periods of market stress (i.e., the majority of 2022).

In this context, strategies that combine a mix of equity factors (e.g., quality, value and low volatility) or single factors, such as low volatility strategies, with sustainable tilts such as lower-carbon tilts, may make sense to some investors.

A number of considerations need to be taken into account when developing and implementing these strategies. Risk premia factors and sustainability factors can show patterns of influencing each other. For instance, governance metrics have been positively correlated with quality factors historically. On the other hand, some value factors and carbon emissions have been negatively correlated in the recent past.

Furthermore, many interactions between equity factors and sustainable factors are subject to causal relationships in both directions which makes decomposing portfolio returns into separate contributions from risk premia, industry, country and now sustainability components a relative complex task. However, there are still many routes investors can take in constructing ESG investment portfolios.

Climate strategies considering social aspects, or SDGs in the context of 'just and fair' transitions

We have also seen increased attention to mitigating social effects of the transition to a low carbon economy. For some emerging markets it might be hard to transition their economies without increasing the related social costs (e.g., the closing of coal-related businesses can lead to unemployment, which can aggravate poverty, and can also jeopardize equitable distribution of electricity). We believe avoiding unintended and knock-on social effects as societies move to lower-carbon economies is important to achieve a 'just and fair' transition.

In this context, climate tilts combined with social and gover¬nance tilts that measure the "S" and "G" components with metrics around progress toward the UN Sustainable Develop¬ment Goals (SDGs) can gear a climate portfolio with a broader sustainable objectives

SDG-aligned investment looks set to be a trend in the coming years. However, from our experience there are challenges in the current data, for example: 1) sector biases in a number of SDGs due to the nature of each SDG; 2 Different methodologies for measuring specific SDG alignment can make it difficult to identify companies' exposure to SDGs.

For example, from a strict revenue exposure perspec¬tive SDG 3 (Good Health and Well-Being) tends to be dominated mostly by health care companies. Likewise, with SDG 5 (Gender Equality), identifying companies with products promoting specifically gender equality is not straightforward exercise. However, this area of data methodologies is experiencing increasing attention and innovation by the financial community.

Decarbonization and net-zero

The third trend we are seeing is the evolution of climate/ carbon strategies to portfolios specifically aligned to the Paris Agreement, with the goal of achieving clients' net-zero ambitions. These strategies have moved from measuring the relative carbon reductions with respect to a broad market benchmark to measuring the carbon reduction with respect to the portfolio over time. A portfolio can be measured against a base year to assess how it is decarbonized over time in line with an implied net-zero trajectory. For example, by incorporating a 1.5° climate scenario target estimated by a framework such as the IPCC (UN Intergovernmental Panel on Climate Change).

Measuring portfolio-level decarbonization is one of the key pillars of a net-zero investment strategy. However, most low carbon strategies have focused on carbon scope 1 and 2 metrics. Recently though, due to better data availability, scope 3 has been gradually added. More specifically, in certain industries in which scope 3 data is material and/or the levels of disclosure and data accuracy are acceptable (such as energy companies and automobiles), asset owners are encouraged to include these emissions to form a 'selected scope 3'.

Also, there are two main approaches in measuring the carbon exposure of a portfolio, weighted average carbon intensity (WACI) and carbon footprint. The WACI approach uses portfolio weights to get an 'average' carbon intensity metric of a given portfolio. The ownership approach uses the ratio between the value invested and the overall size of a company as measured by EVIC or market capitalization (i.e., the level of investor's ownership of the company).

Adding it all up

Investors are increasingly seeking flexible and customizable sustainable portfolio solutions to help meet the range of climate and sustainability needs. To overlook rules-based strategies would, in our opinion, be a mistake.

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