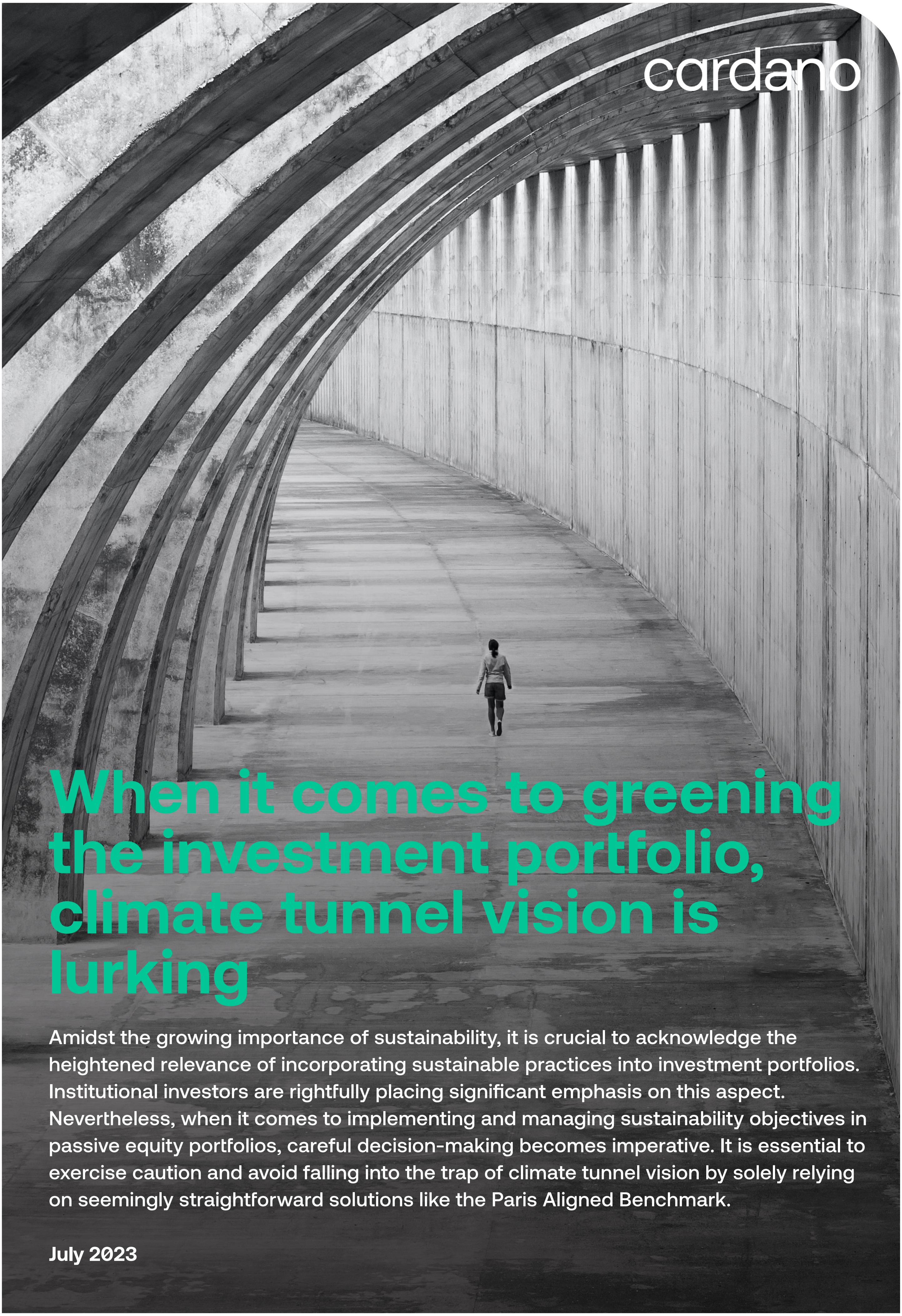

When it comes to greening the investment portfolio, climate tunnel vision is lurking

Amidst the growing importance of sustainability, it is crucial to acknowledge the heightened relevance of incorporating sustainable practices into investment portfolios. Institutional investors are rightfully placing significant emphasis on this aspect. Nevertheless, when it comes to implementing and managing sustainability objectives in passive equity portfolios, careful decision-making becomes imperative. It is essential to exercise caution and avoid falling into the trap of climate tunnel vision by solely relying on seemingly straightforward solutions like the Paris Aligned Benchmark.

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Recognizing the need for enhanced standards and guidelines in sustainable investing, the European Union introduced two benchmark types in late 2019: the Paris Aligned Benchmark (PAB) and the Climate Transition Benchmark (CTB). These benchmarks have garnered increasing attention from Dutch pension funds and insurers, although their initial adoption was met with some caution. By aiming to align with the goals of the Paris Climate Agreement, both benchmarks prioritize reducing CO2 emissions, aspiring to create a climate-neutral world by 2050.

Experts

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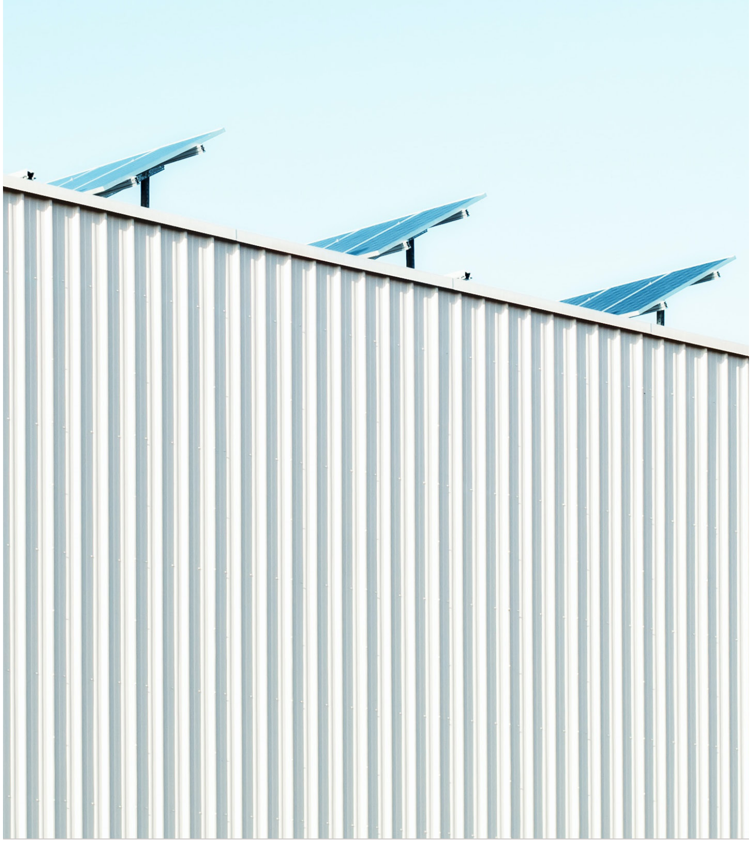
A climate-neutral world by 2050 as a goal.



Convenience can carry risks

There is an undeniable consensus among institutional investors regarding the importance of contributing to the goals outlined in the Paris Agreement. At first glance, adopting a Paris Aligned Benchmark (PAB) may seem like a simple and convenient way to implement and manage sustainability ambitions within an investment portfolio. However, it is crucial to recognize the intricate complexities and challenges that accompany this approach towards achieving net-zero emissions. Surprisingly, relying solely on a one-dimensional benchmark such as the PAB can lead to unexpected inconveniences and risks across various facets. Contrary to its name, the PAB falls short of fully addressing its implied objectives and hence is not entirely future proof. It is crucial to understand that while the term "Paris Aligned Benchmark" implies exclusivity, there are numerous alternative pathways for aligning investment strategies with the goals of the Paris Agreement.

As we look ahead, social objectives will emerge

Sustainable investing is gaining momentum in the realm of pension funds. Presently, sustainability is largely associated with adhering to the Parisian principles of CO2 reduction and the exclusion of fossil energy. While the PAB and CTB align with these principles, they primarily reflect the current sentiments and priorities. However, looking ahead, the green EU taxonomy for sustainable investing is set to evolve by encompassing a social taxonomy. This expanded framework will incorporate social objectives concerning housing, employment, health, and infrastructure, aspects that are currently not addressed by the PAB. Additionally, important ecological concerns like biodiversity and deforestation are currently not explicitly considered within the PAB.

The PAB is a one-trick pony

In the forthcoming years, it is undeniable that the PAB will face limitations as emerging topics are not covered by its principles. Consequently, this can lead to its transformation into a one-trick pony. For example, the EU Taxonomy recognizes the significance of factors such as biodiversity, circularity, water, and pollution, which the PAB fails to encompass. While the PAB may provide a short-term solution, it consumes a significant portion of the risk budget by focusing solely on one theme. Additionally, the PAB does not adequately address all future responsibilities, leaving room for potential climate tunnel vision. As new desires or requirements emerge in the PAB aligned portfolio, readjustments, heightened management attention, project implementation, transaction costs, and other adjustments will be necessary.

Other threats to livability

The notion that carbon-neutral investing is synonymous with climate-neutral investing overlooks the broader threats to livability. Achieving a carbon-free world alone does not guarantee the fulfillment of the climate goals outlined in the Paris Agreement. Other substances and gases, such as particulate matter and methane, pose significant challenges to livability. While CO2 accounts for 67% of climate change causation, the remaining 33% is inadequately addressed within the framework of a Paris Aligned Benchmark (PAB). This realization emphasizes the importance of adopting a more holistic approach to investment portfolios that considers these overlooked factors. Additionally, by embracing a PAB, investors relinquish a certain degree of control over their investment policy, as it becomes fixed for a specific period, hindering the flexibility needed to adapt to emerging insights and changing circumstances

Exclusion is a paper transaction

Benchmarks like the PAB and CTB establish a target of a 50% reduction in carbon footprint compared to the broad benchmark. However, the feasibility and effectiveness of this objective in contributing to the goals of the Paris Agreement are subjects of scrutiny. These benchmarks do not have any real-world impact. The reduction in footprint is not automatically realized in the actual economy. While adhering to the PAB may lead to a reduced exposure to high-emitting companies within the portfolio, it is important to acknowledge that other investors may continue to invest in such companies. Thus, the exclusion of fossil fuel companies becomes more of a symbolic transaction on paper rather than driving the necessary energy transition that must materialize in the real world and the functioning economy.

The holistic approach requires a conscious choice by the investor in light of what they want to achieve with the sustainable portfolio.

Impact on the real economy

A holistic approach to portfolio management not only aims for a greater real-world impact but also recognizes and encourages the transformative potential of companies that may not currently meet sustainability standards. This approach involves active engagement, whereby investors proactively address and guide companies towards behavioral changes that foster sustainability. As these companies subsequently evolve their behavior, product offerings, and production processes, the portfolio effectively drives positive change in the real economy. It is no wonder that there is a growing call to invest in transitioning companies. Companies like Tata Steel and Yara exemplify the need for capital investment alongside the opportunities and willingness to transform. Embracing such a holistic approach requires conscious decision-making by investors based on their desired objectives and the transformative potential they aim to achieve within their sustainable portfolio.

Many sustainability-related risks

A non-holistic perspective oversimplifies reality and poses significant risks when evaluating investments. Relying solely on a PAB can lead to the inclusion of companies that are exposed to physical risks or operate within vulnerable supply chains. Unintentionally, this approach overlooks numerous sustainability-related risks, leaving PAB investors inadequately prepared for potential challenges. Such a one-sided investment strategy falls short of meeting the risk recognition expectations set by regulatory bodies such as the EU, DNB, and WEF, making it less future-proof. For example, the EU taxonomy emphasizes the consideration of six factors, of which only two are climate-related. Similarly, the DNB highlights the importance of financial institutions recognizing and mitigating sustainability-related risks, encompassing climate, water, natural resource use, and human rights violations.

Not all PABs are the same

Interestingly, sustainable investing lacks a fixed definition, resulting in significant variations in interpretation among different providers. While guidelines exist to establish minimum requirements, the understanding and implementation of sustainable investing differ greatly across the industry. The European Union's introduction of the PAB and CTB aims to enhance transparency for end investors. The main distinction between these benchmarks lies in the CTB's flexible reduction targets and absence of sector exclusions. Although both benchmarks strive for uniformity, it is crucial to recognize that not all benchmark providers are the same, and variations exist among different PABs or CTBs. Consequently, the notion that the choice of benchmark for investing in line with the Paris Agreement is inconsequential is misguided. Significant differences exist between providers, including exclusion policies and portfolio construction methodologies. Hence, it is essential to take careful steps, consider all relevant factors, and prioritize the core principles of the investment fund before making an informed decision. While opting for a PAB or CTB may align well with these principles, it is vital to avoid falling into a false sense of security. It is crucial to acknowledge that multiple paths can lead to achieving sustainability goals. Adopting a holistic approach involves considering all potential pitfalls along the journey rather than solely focusing on one visible hurdle.