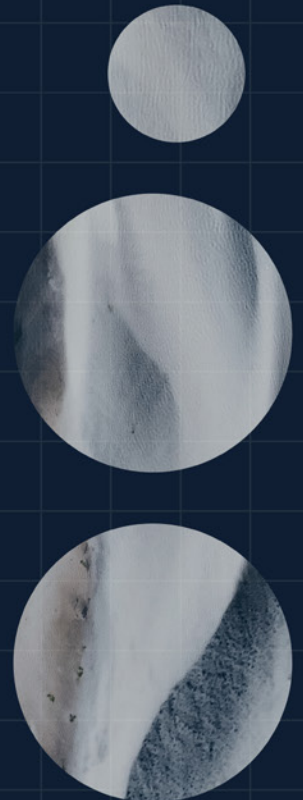
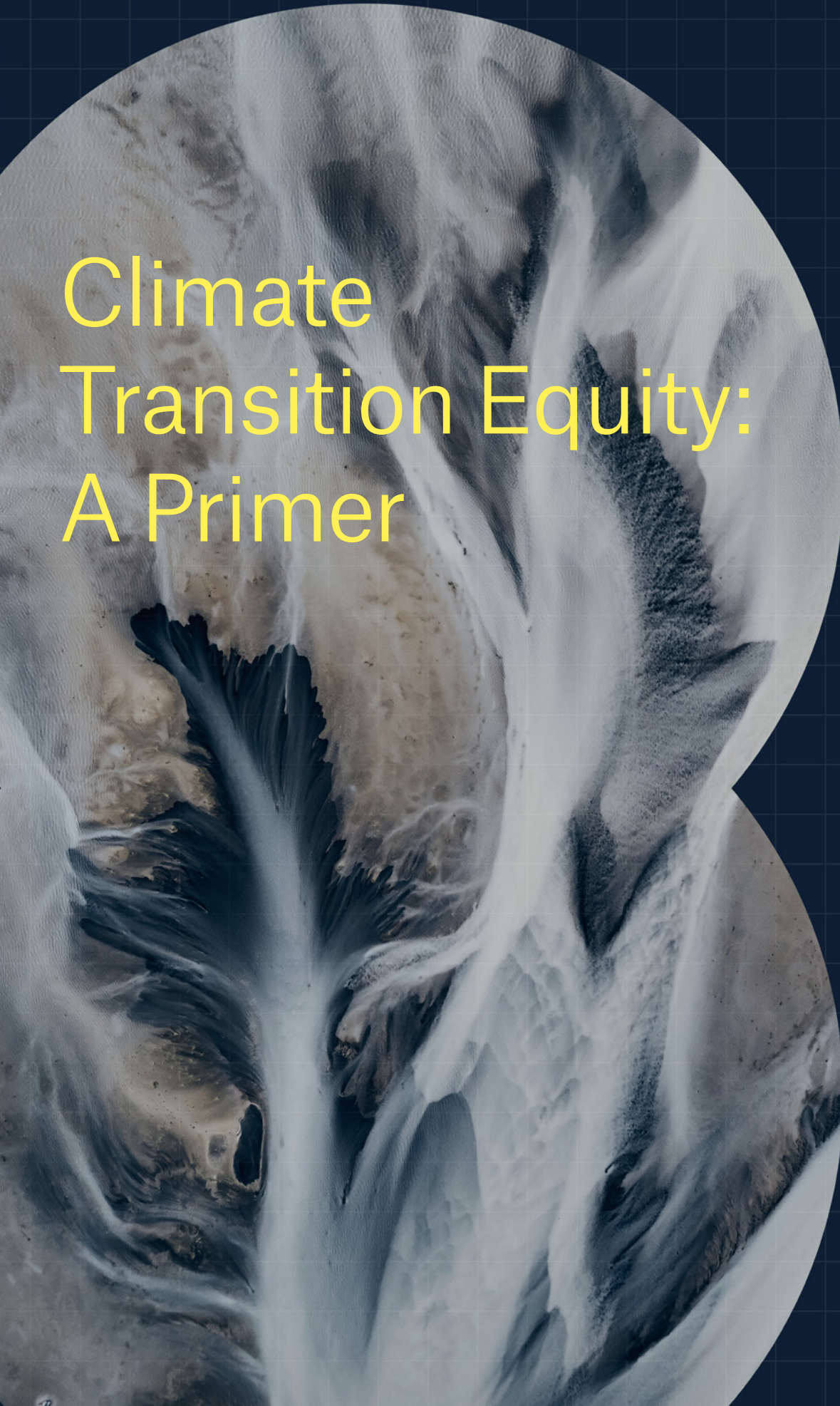


Climate Transition Equity: A Primer



Summary

Climate transition aims to align the current economy with the Paris Agreement's aspirations. Setting climate transition as a dedicated investment goal offers benefits such as focusing on material transition risks, staying close to the real economy, and potentially creating more balanced portfolios.

This paper examines current predominant first-generation frameworks, highlighting improvements through second-generation approaches. We then introduce the methodology and design principles of our climate transition equity strategy. Finally, we summarise recent conceptual and theoretical developments to enhance understanding of key transition terminology and literature.

1 Introduction

In 2023, the average global surface temperature reached its highest level since records began in 1850, with ocean temperatures showing record warmth for nine months¹. While some are losing faith in transitioning the world to alignment with a well below 2°C pathway², others affirm that this remains possible if momentum and ambition increase rapidly³.

These rapid changes generate transition risks for corporates. Such risks may arise from legal actions, policy changes, reputational issues, shifting consumer preferences, and supply and demand fluctuations, all of which can be financially material. The key driver of materialising transition risks for corporates and, an effective macroeconomic tool for decarbonisation towards net-zero, is putting a price on carbon emissions. While the number of jurisdictions with carbon pricing instruments is growing significantly, it is not growing sufficiently – as recently concluded by the Net Zero Asset Owner Alliance (NZAOA)⁴.

Ultimately, decarbonisation of business must be delivered by corporates across all sectors. Corporate net-zero aligned emission reduction targets and commitments almost quadrupled between 2020 and 2022⁵. Transition Plan Frameworks (TPFs), guiding corporates to track and account for credible progress on these targets and commitments, are numerous and strongly driven by regulation and Standard setters⁶. To achieve credibility, TPFs have to be verified, monitored, and delivered.

Meanwhile, climate-focused asset allocators have plenty of choice of climate-themed funds. Globally, Climate funds have increased 14-fold between 2018 and the first half of 2023. According to Morningstar, funds classified as climate transition, represent the largest category of climate-themed funds and have seen the highest inflows.⁷ However, the same analysis highlights the conceptual fuzziness and heterogeneity of these climate transition funds.

2 From 1st to 2nd Generation Climate Investment Solutions

Low-carbon equity investment strategies set the early ground for the evolution of climate funds. The success of such strategies mostly relies on their simplicity of divesting or underweighting high emitting sectors and corporates. Based on a "80/20" rule of thumb principle, divesting 20% of high emissions holdings leads to an 80% improvement of the portfolio CO₂ KPI.

In 2020, the EU established a standard to achieve net-zero portfolio emissions through the Climate Transition Benchmark (CTB) and the Paris Aligned Benchmark (PAB). Both benchmarks have a significant role in the regulatory and climate-themed equity product landscape today.

These first generation climate investing solutions introduced portfolio level emission reductions as a critical investment goal. For example, CTB and PAB require a fixed emission intensity reduction of 30% and 50%, respectively, compared to the parent universe, along with a rolling 7% annual decline. Potential improvements to these benchmarks have been well-described^{8,9} primarily addressing the cosmetic nature of decarbonising by divesting carbon-intensive issuers and sectors.

All first generation climate equity strategies risk that, while portfolio emissions are significantly improved by selling stocks into the market, the real economy continues to not be aligned with net-zero targets. In other words, portfolio improvements are easy to achieve by the click of a few trades, whilst real world corporate carbon abatement is a challenging goal which takes many years. First generation strategies often also optimize portfolio emissions purely based on backward looking carbon metrics. From a planetary perspective, such emissions may have already been concentrated into the atmosphere and cannot be abated any more.

Financially, first generation climate strategies risk experiencing performance swings versus market benchmarks. This may be the result of sector deviations and portfolio concentrations resulting from applied portfolio level carbon KPI reduction goals.

Second generation climate equity strategies seek to address all these challenges. Their goal is to build maximum exposure to climate transition leaders across all sectors, to approximate the real economy, while delivering a financial profile that is in line with market benchmarks. These strategies complement backward-looking emissions data with forward-looking metrics, such as scenario-aligned targets or capital expenditures in climate solutions.

Table 1: Comparing Paris-aligned Benchmarks

	MSCI Europe €	MSCI Europe Climate Change € (CTB)	MSCI Europe Paris Aligned € (PAB)
Constituents	420	389	239
Tracking Error (%)	-	1.74	2.38
1Y/3Y/5Y Annualized Excess Returns (%)	-	-0.3/-0.96/0.02	-2.15/-1.51/0.3
Owned Emissions (tCO₂e/mUSD)	Scope 1 + 2	28.1	9.2
	Scope 3	518.6	172.5
Portfolio Implied Temperature Rise	2.1°C	1.9°C	1.9°C
Top GICS Sector Deviations		Energy -5.6% Consumer Staples -4.4% Industrials +4.3% Health Care +4.7%	Energy -5.8% Consumer Staples -4.4% Real Estate +2.5% Industrials +6.5%

Source: MSCI Inc. Index weights collected as at 2024-04-30. GICS Sectors, Tracking Error and Excess Returns sourced from MSCI factsheets, all as at 2024-04-30. Climate Metrics calculated with most-recent available enterprise value including cash (EVIC) based attribution as at 2024-04-30. Scope 3 data is purely based on MSCI's estimation model. Portfolio ITR calculated from aggregated budget approach as suggested by GFANZ¹⁰.

Table 1 shows that first generation solutions indeed deliver much lower owned emissions compared to that of the broad market index. The performances are around par at a 5-year horizon with the benchmark, but more recent underperformance is evident even at a 3-year horizon. The carbon reductions, however, come with underweights in carbon-intensive sectors like energy and consumer staples. Additionally, the focus on reduction based on backward-looking emissions is not fully aligned with the forward-looking metrics like Implied Temperature Rise (ITR), as the much lower carbon emissions for PAB translate to a similar ITR to that of CTB.

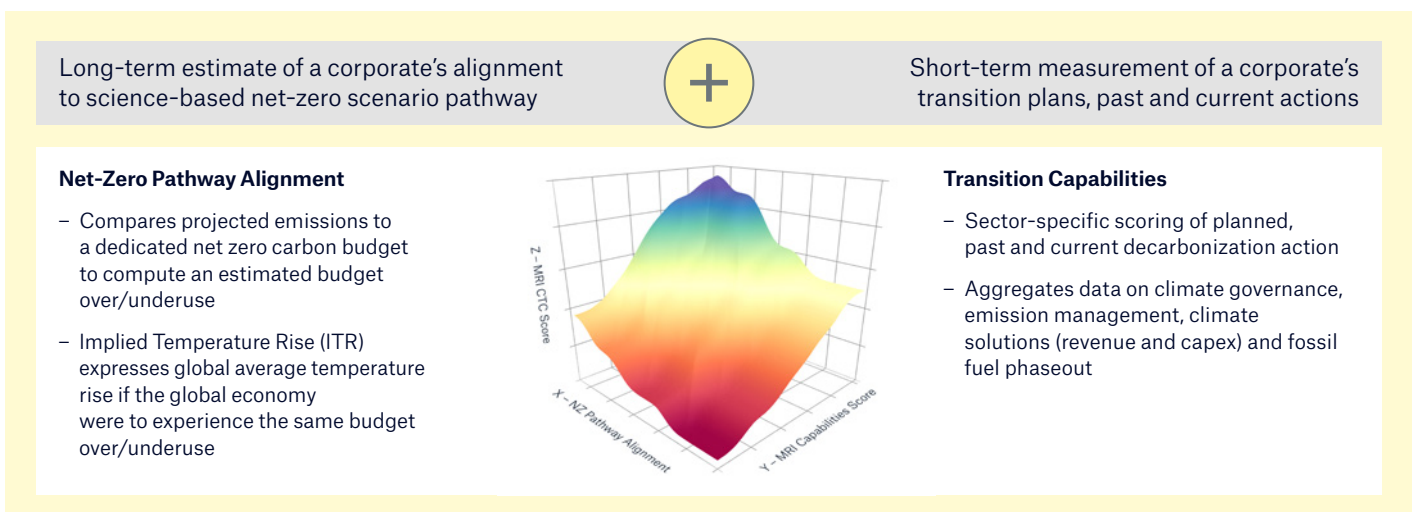
The strategy seeks to maximise exposure to climate transition leaders across all sectors, powered by a proprietary assessment of companies' long-term net-zero aspiration, cross validated with their short-term transition capabilities.

We have developed a sector-specific, expert-rules-based scoring methodology to create the Climate Transition Corporate (CTC) Score. The CTC Score integrates climate metrics from different vendors, combining a long-term estimate of corporate alignment with science-based net-zero pathways and a short-term measurement of a corporate's transition plan and execution. The CTC Score is the centrepiece of our strategy and plays a significant role in the portfolio construction process.

3 Climate Transition Equity Strategy

In this section, we outline Munich Re Investment Partner's climate transition equity strategy which incorporates second generation considerations.

Figure 1: The Climate Transition Corporate Score



The strategy adheres to the following design principles:

- We want to contribute to real-economy decarbonisation across all sectors, by considering science-based, regional and sector specific net-zero pathways. Our approach builds on recognized climate investment frameworks such as from GFANZ.
- We aim to ensure transparency in methodology and design. Constituents and weights are explainable and predictable.
- While applying exclusions defined on recognized criteria, we seek to avoid mechanical exclusions of high-emitting sectors but use a tilting approach to favour climate transition leaders over laggards, while applying the sanity principle of "do no significant harm".
- We consider forward-looking metrics (such as capital allocation, targets, projected emissions) essential inputs. Climate Solutions are a principal component of transition.
- Conversely, we consider fossil fuel dependency and expansion of a corporate's business strategy.
- We are aware of the significant uncertainty around climate science, corporate ambition, as well as political ambition, and seek ways to actively manage that.
- Transition concept compliance, information gain for assessing alignment, and data quality are the three key selection criteria for datasets and data providers used in this strategy.
- Given the diversity of investor needs and their varying positions on transition journeys, we aim for a scalable and systematic, approach powered by a strong analytics technology platform.

4 Conceptualising Climate Transition Investing

4.1 Climate Transition

Mankind has experienced various energy transition periods such as, for example, from wood to coal. Here, we mean a transition to a state where the real economy achieves net-zero greenhouse gas emissions. A state, when anthropogenic emissions of greenhouse gases to the atmosphere are balanced by anthropogenic and atmospheric removals; a state effectively aligning with the Paris-agreement goal of limiting global average temperature increase to well below 2°C while pursuing 1.5°C above pre-industrial levels.

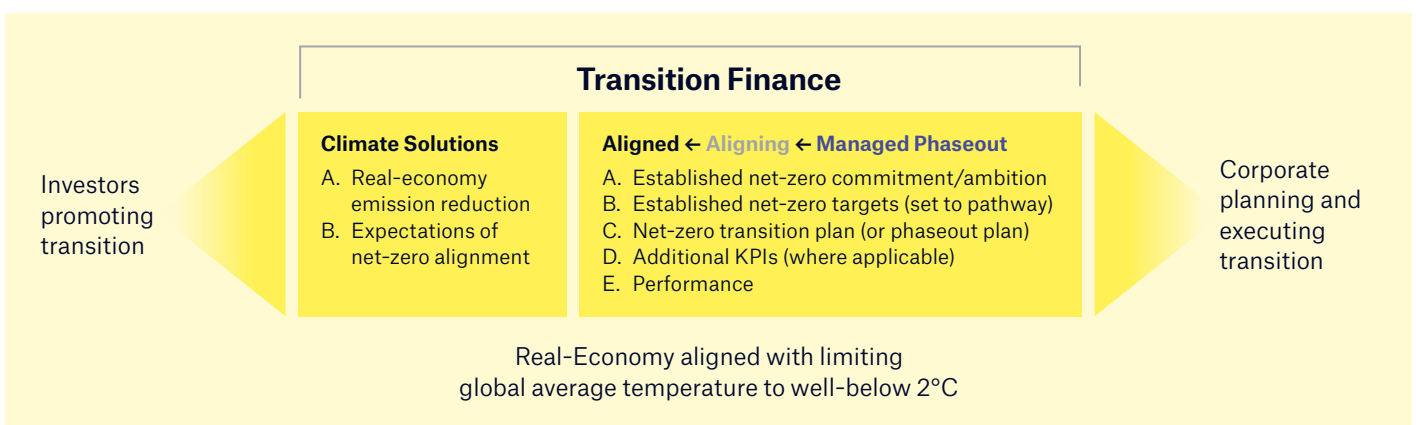
There are various climate scenarios exploring pathways towards achieving this state. Prominent sources include the International Energy Agency (IEA)¹¹, the Network for Greening the Financial System (NGFS)¹², and the One Earth Climate Model (OECM)¹³. They inform a remaining global carbon budget, set out emission reduction requirements, assume technological progress and requirements and therefore allow for different paces of reduction as well as overshoot limits. With the purpose of setting and assessing 1.5°C aligned targets, Sectoral Decarbonisation Approaches (SDA) translate such global budgets into sector and regional specific decarbonisation pathways of carbon intensities.

4.2 Transition Investing

We believe GFANZ has been strongly delivering on the conceptual clarity of climate transition. With the goal of supporting an orderly real-economy transition to net-zero, GFANZ suggests four key transition financing strategies^{14,15}, which link corporate transition planning with investor requirements.

To construct a climate transition equity strategy, we found several additional frameworks and guidance to be particularly helpful. For corporate transition planning and net-zero pathway alignment, the CA100+¹⁶, TPI¹⁷, and SBTi¹⁸ are fundamental. For investors, the IIGCC's¹⁹ Net Zero Investment Framework and GFANZ's guidance on portfolio alignment²⁰ are useful resources. IIGCC has consolidated these and other frameworks into a cohesive view on transition key components, affirming the GFANZ Transition Finance conceptualization²¹.

Figure 2: GFANZ Key Transition Financing Strategies



We understand aligned, aligning, and managed phaseout categories as a gradient. One company might need to start with phasing out high-emitting assets²². For another company, there might be nothing to phase out, but aligning still needs to happen. Despite these differences in progress, both companies need to provide two things:

1. Comprehensive, net-zero-aligned, emissions reduction commitment and targets. A breakdown into short, medium, and long-term targets, covering all material GHGs, emission scopes, regions, and business activities. Plus, consistency with 1.5°C low/no overshoot pathways.
2. A credible strategy and a transition plan to convert targets into decarbonisation. The most critical components are:
 - a. Climate Governance, including board oversight of decarbonisation, clear responsibilities, executive remuneration tied to transition performance as well as adequate board competencies.
 - b. Capital allocation, which is not contradicting phaseout requirements under low/no overshoot scenarios and explains intended investments in climate solutions.
 - c. Clarity about the current and future role of Climate Solutions for decarbonising own operations or enabling others to do so.

Climate Solutions hold a special place in this concept. We suggest using the definition proposed by IIGCC²³ to build a common understanding of Climate Solutions.

Climate Solutions are activities, goods, or services that contribute substantially to, and/or enable, emissions reductions to support decarbonisation in line with credible 1.5°C pathways towards net zero, or that contribute substantially to climate adaptation (IIGCC).

Investors need to understand the impact on portfolio emissions, especially through the distinction of Transition and Enabling Climate Solutions: Transition Climate Solutions yield emissions reductions within corporate operations (Scope 1+2 resp.). Enabling Climate Solutions yield reductions within the corporate value chain (Scope 3 resp.) or the wider economy.

To identify climate solutions, investors can use local taxonomies (e.g., the EU Taxonomy). We recommend following the above referenced IIGCC guidance and adopting a more open approach to classify climate solutions, which considers the significant and urgent investment requirements.

- Taxonomy-aligned: are Climate Solutions that require technical screening criteria (TSC), which ensure a substantial contribution to the objective climate change mitigation and adaptation, while also meeting “do no significant harm” (DNSH) and minimum social safeguards.

- TSC-aligned: are Climate Solutions that require a substantial contribution to the objective climate change mitigation and adaptation, but do not necessarily meet all DNSH criteria. Naturally, upholding DNSH principles for sustainability-themes funds is essential, yet it should not restrict the classification of climate solutions.

- Taxonomy-equivalent: in the absence of local taxonomies, investors may consult other local regulations and standards (e.g., building standards, emissions standards) to identify climate solutions, substantially contributing to climate change mitigation and adaptation.

- Extra-taxonomy: there are activities currently not covered by local taxonomies, which can be critical for transition. A good example are key transition minerals (e.g., Lithium, Copper) as recently defined by CA100+^{23,24} which must increase most rapidly according to net-zero scenarios.

Finally, investors should consider Climate Solutions as transition opportunities and a complementary perspective to transition risks. Net-zero scenarios provide insights into the necessary technologies and investment levels required to achieve decarbonization across different sectors and regions. For example, the IEA Net Zero Scenario calls for clean energy investments of 4 trillion USD by 2030²⁶. Such investment gap analyses^{26,27}, demonstrate that the transition is not only a risk but also an opportunity for investors.

5 Terms

GFANZ:	Glasgow Financial Alliance for Net Zero
NZAOA:	Net Zero Asset Owner Alliance
CDP:	Carbon Disclosure Project
SBTi:	Science Based Targets initiative
IIGCC:	The Institutional Investor Group on Climate Change
CA100+:	Climate Action 100+
GHG:	Greenhouse Gases

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