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Equity strategies to support institutional investors' climate and performance targets

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Climate targets of institutional investors

A large number of institutional investors around the world have voluntarily committed to implementing ambitious climate targets in their investments. The members of the Net-Zero Asset Owner Alliance (NZAOA) are spearheading this endeavour. As of January 2025, this initiative comprises 89 members with US\$ 9.5tn in assets under management (AuM). 81 of the members have published concrete, predominantly quantitative interim decarbonisation targets that focus on the majority of the invested funds, US\$ 8.4tn of AuM.¹ The NZAOA's current fourth target-setting protocol sets a CO₂ reduction target of 40–60% compared to the base year 2019 for the period up to the end of 2029 across various sub-portfolios.² The NZAOA is aiming for "net zero" greenhouse gases by 2050.

According to the German Insurance Association, around 90% of German insurers have currently set themselves a CO₂ reduction target, measured as a percentage of their investments. More than half of them are members of the NZAOA.³

The publication of ambitious CO₂ reduction targets for investments creates strong pressure to realise these targets. This is also the case for the public equities segment. Most investors have already achieved very good results here thanks to their efforts. On average, the members of the NZAOA have set themselves a decarbonisation target for public equities for 2024 vs. 2019 of around minus 27–28% for intensity-based or absolute emissions.⁴

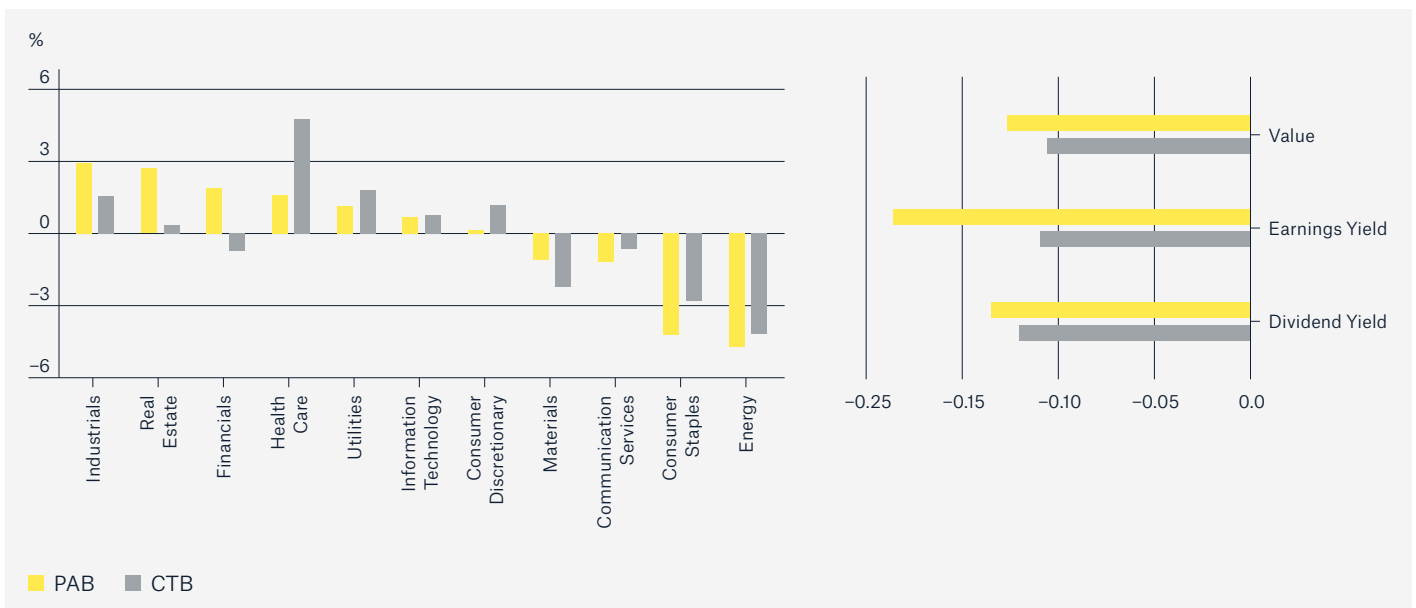
Investor preferences for climate equity strategies

In dialogue with institutional investors both within and outside Europe, for example superfunds in Australia, their CIOs and equity portfolio managers often express the desire to develop new ideas to achieve climate targets sustainably whilst at the same time performing close to the benchmark, as well as the success of decarbonisation.

To date, high CO₂-intensive individual stocks have often been sold or underweighted in order to achieve climate targets, which is a pragmatic approach for equity portfolios as the investment strategy does not have to be changed. In many cases, however, such an approach involves accepting not inconsiderable disadvantages for the portfolio. For example, third-party analyses of European and North American equity portfolios show that a CO₂ reduction of more than 50% at portfolio level can lead to significant negative performance deviations compared to the original portfolio. Specifically, in the simulation, an 80% reduction in CO₂ for North American equities resulted in a 6% underperformance – with a simultaneous increase in volatility of 2% or more.⁵

Climate Transition and Paris-Aligned Benchmark equity strategies (CTB and PAB), which are based on EU minimum standards, must decarbonise by at least –7% annually at portfolio level in addition to an ad-hoc CO₂ reduction of –30% or –50% relative to the market benchmark.⁶ Many EU-domiciled asset owners honour these strategies as they give them a certain degree of regulatory certainty. However, concerns are often expressed in dialogue about the future performance and risk effects of these dynamic "carbon overlay" strategies. Especially if the majority of companies in the real economy decarbonise at a slower rate than 7% p.a. Global absolute emissions increased by an estimated CAGR of +2.4% between 2020 and 2023. In the EU 27, there is a slight reduction measured by the CAGR of an estimated –1.67%.⁷

Figure 1: Sector and factor shifts in the MSCI CTB and PAB Europe Equities indices



Source: Munich Re Investment Partners, analysis as at 31.12.2024

Furthermore, structural sector and factor shifts can occur in equity portfolios, which are the source of undesirable performance deviations from the market benchmark over various market cycles. As can be seen in Figure 1, MSCI CTB and PAB Europe show an overweighting of the “Industrials” and “Healthcare” sectors and an underweighting of “Energy” and “Consumer Staples”. Both strategies are underweighted in the Value, Earnings and Dividend Yield factors.

In addition to the performance aspects, discussions with institutional investors increasingly reveal a critical reflection on the possible decoupling of decarbonisation equity strategies from the real economy. In many cases, companies and key industries that produce mission-critical products and services or energy for the green economic transformation are being discarded as uninvestable due to their current CO₂ intensity. However, digital “yes/no” CO₂ investment criteria ignore the fact that in the real economy, the vast majority of companies manage a complex mix of business activities and need time for profitable transformation. While equity portfolio managers in liquid markets can decarbonise their portfolio with just a few trade clicks, capital-intensive industrial companies have asset durations of several decades in extreme cases, which can only be transformed in the medium to long term. These companies need access to capital markets in order to finance the necessary transformation investments, “Green CapEx”, and to expand the share of sales of climate-friendly products and services.

Climate Transition equity strategy to optimally support the investment objectives

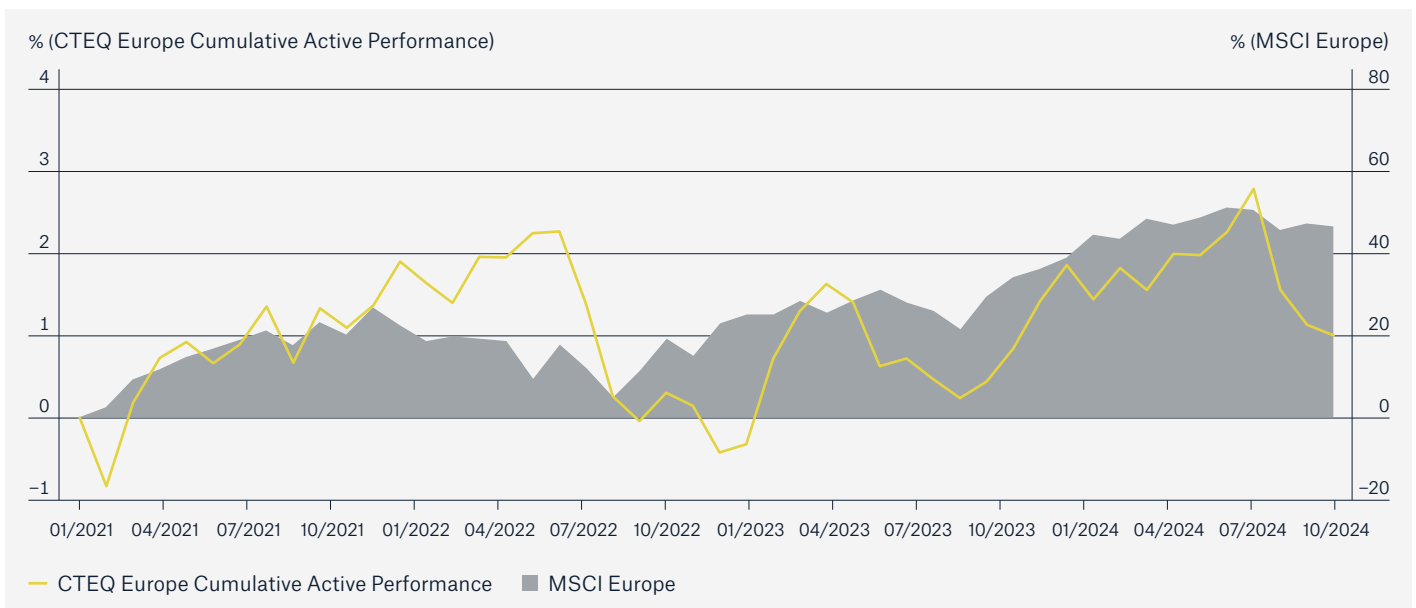
Climate transition equity strategies represent a solution and further development. The aim of these strategies is to maximise exposure to companies across all sectors in the portfolio that are leaders in their business climate transformation. At the same time, a systematic portfolio construction process and strict portfolio risk management aim to achieve benchmark-like investment performance.

Using the MSCI Europe as an investment benchmark, we illustrate the structure of a possible Climate Transition Equity Strategy (CTEQ) below. In principle, the strategy invests in 180 to 220 companies, with the portfolio beta also being set to around 1 during optimisation.

A forward-looking Climate Transition Score methodology is proposed as a central evaluation criterion for the climate transformation strength of companies, which will be examined in more detail below as the “centrepiece” of the strategy.

Figure 2 shows the backtest in the form of a performance close to the benchmark with moderate tracking error using the Climate Transition Score “CTC” as an example in this article.

Figure 2: Performance comparison of the Climate Transition equity strategy with the MSCI Europe benchmark index



Source: Munich Re Investment Partners, analysis as at 31.12.2024

Notes: The historical performance of the CTEQ strategy is based on quarterly backtesting. Backtesting involves evaluating an investment strategy using historical data to simulate what the performance of such a strategy would have looked like in the past. The cumulative active performance determined by backtesting is purely hypothetical and is presented for information purposes only. The data collected through backtesting does not represent actual performance and should not be relied upon as an indicator of actual or future performance. Performance presentation before fees.

Climate Transition Scores using the example of the “CTC” in detail

A forward-looking approach is suitable for evaluating individual benchmark companies in terms of climate transition strength. A large number of metrics and methods now exist for this purpose. For example, it is analysed whether a company has set itself scientifically comprehensible, externally verified decarbonisation targets. The Science Based Targets Initiative (SBTi) is an internationally established platform that now supports more than 10,000 companies in setting “net zero” emissions reduction targets.⁸ More comprehensive “transition score” approaches combine a company’s estimated contribution to global warming, the company-specific transition risks that may result from a higher emissions rights price, for example⁹, the percentage of investments, costs and revenues that flow into the green transition and climate solutions, as well as other criteria.¹⁰

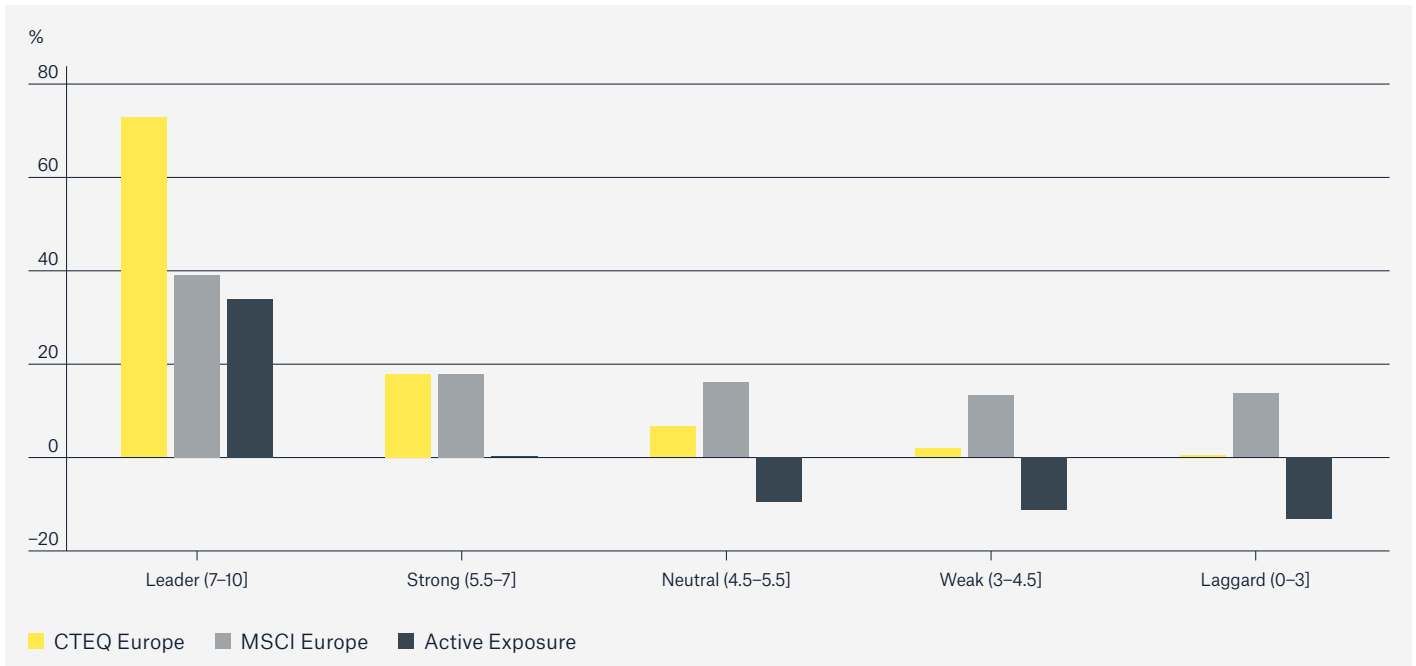
Overall, no standard has yet been established. Different approaches often assess one and the same company very differently.¹¹ The CTC score presented here is methodologically based on internationally recognised frameworks such as the Transition Pathway Initiative (TPI), Climate Action 100+ (CA 100+), the Science Based Target initiative (SBTi) and the Institutional Investors Group on Climate Change (IIGCC).¹² In addition, there is a particular focus on the recommendations of the Glasgow Financial Alliance for Net Zero (GFANZ)¹³. This broad-based approach is intended to ensure that the score is as objective and robust as possible.

In our opinion, a forward-looking Climate Transition Score should consider two dimensions in particular, either alternatively or cumulatively:

- Long-term dimension: The expected deviation between the company’s projected cumulative absolute emissions from today until 2050 and a company-specific emissions budget. The latter is derived from a global scenario that aims for climate neutrality in accordance with the Paris Climate Agreement (“Net Zero Pathway Alignment”). In the example, the “Net Zero 2050” scenario of the Network for the Greening of the Financial System (NGFS) is used.¹⁴ It is important to note that the CO₂ budget is based on cumulative, absolute emissions and not on relative emission intensities. Only the former are relevant for the extent of global warming. The key figure derived from this is expressed in terms of the company’s potential contribution to global warming on a scale of 1.3°C to 10°C.¹⁵
- Short-term dimension: The company’s transition strength as well as past and present decarbonisation capabilities (“transition capabilities”).

For the CTC score used as an example in this article, we have considered both dimensions cumulatively for reasons of better resilience. For this purpose, the dimensions are linked to a score between 0 and 10 using sector-adjusted models.

Figure 3: Significant overweighting of Climate Transition Leaders



Source: Munich Re Investment Partners, analysis as at 31.12.2024

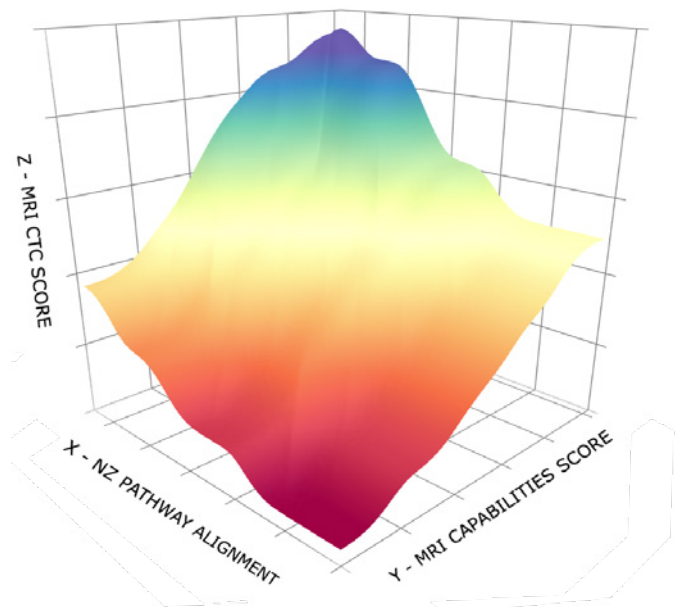
The investment objective is to significantly overweight the proportion of Climate Transition Leaders in the portfolio. In the example, 91% of the portfolio is invested in strong or leading climate transition companies (CTC 5.5–10), weighted by market value (see Figure 3).

How does a company qualify as a Climate Transition Leader? In the example of the CTC, the prerequisite is that the forecast, plausibility-adjusted cumulative emissions are less than or equal to its CO₂ budget. Furthermore, the company must demonstrate decarbonisation strength. In the example of the CTC, there are various criteria such as:

- High assessment of emissions management and actual decarbonisation successes of the company.
- Strong expansion of climate solutions. Using the MSCI Europe as an example, rising sales and CapEx shares according to the EU taxonomy ("climate mitigation") are suitable indicators here.
- High credibility for phasing out fossil fuels such as thermal coal, gas and oil.

Techniques such as "Fuzzy logic" and "if/then rules" can be used to link the two dimensions. The aim is to make the CTC robust in the company-specific scoring categorisation, as well as completely transparent and explainable along the investment universe. In the example, the result is illustrated using a three-dimensional surface (see Figure 4).

Figure 4: Three-dimensional surface of the CTC



Source: Munich Re Investment Partners

Climate Transition Leaders whose CTC is in the blue area of the chart are suitable for overweighting in the portfolio. Climate Transition Laggards can be found in the grey area.

The following table illustrates the evaluation of one Climate Transition Leader and one Laggard company from the materials sector in a highly simplified form.

Climate Transition Leader and Laggard in the materials sector: company examples

	CTC Leader	CTC Laggard
CTC Score	7.7	0.9
Long-term dimension		
Implicit contribution to global warming in Celsius	1.6	10
Cumulative projected emissions Scope 1–3 until 2050 mtCO ₂ e		
Corporate objective	42	146
Plausibilised corporate objective	42	175
Budget	36	9
Relative deviation	17%	1,844%
Short-term dimension		
Transition skills score	5.7	1.7

Decarbonisation dynamics of the Climate Transition equity strategy

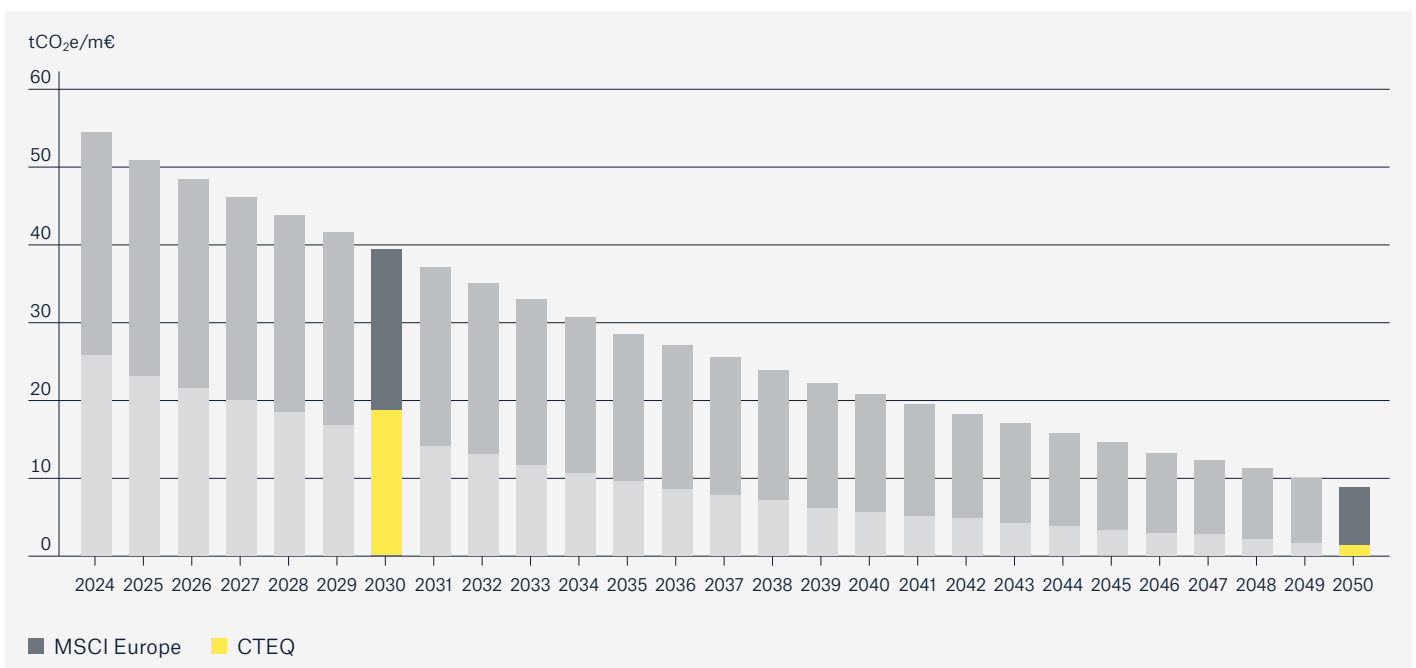
Carbon controlling is important for asset owners who have set themselves dedicated annual or 5-year cycle decarbonisation targets for CO₂ ratio improvements in investments. Especially if the achievement of targets is linked to variable remuneration components.

Climate Transition equity strategies are based on implicit portfolio decarbonisation. Unlike “low carbon portfolio overlay” strategies, no explicit, annual, CO₂ ratio improvement is targeted at portfolio level. A key driver of portfolio decarbonisation is the actual, realised decarbonisation success of the overweighted Climate Transition Leaders over time.

Figure 5 shows the result of a simulation of the portfolio decarbonisation of the Climate Transition equity strategy presented here between 2024 and 2050 compared to MSCI Europe. The year 2030 is emphasised as the intermediate point of the next 5-year plan cycle, which is due at the NZAOA. Portfolio decarbonisation is measured based on intensity-based Scope 1 and 2 CO₂.

Overall, the Climate Transition equity strategy shows a significantly better decarbonisation path than the benchmark. The projection is based on assumptions, in particular that all invested companies will achieve their reduction targets. In reality, decarbonisation is expected to be subject to fluctuations for company-specific or cyclical reasons.

Figure 5: Projected relative carbon footprint of the Climate Transition equity strategy using the example of MSCI



Source: Munich Re Investment Partners

Notes: EVIC-based allocation of forecast Scope 1 and Scope 2 emissions assuming that all company reduction targets are met.

The forecast is based on the CTEQ and MSCI Europe members as at 30 August 2024, assuming a constant EVIC and portfolio composition. In the absence of company reduction targets, the forecast assumes a steady increase in emissions of 1% per year.

Management of an annual portfolio CO₂ target reduction

For many institutional investors, ensuring the achievement of explicit, short-term, e.g. annual CO₂ portfolio target reductions is important in practice. A climate transition approach based purely on implicit decarbonisation must be supplemented. An approach in which asset owners derive CO₂ budgets via their own investments and delegate them to mandated asset managers as investment guidelines in individual amounts is motivated here as a management approach. This relative carbon footprint (RCF), also known as “owned” or “financed emissions”, can be integrated into portfolio optimisation as a secondary condition. The level of the RCF can be set flexibly across different asset classes, invested sectors and countries, as well as depending on the investment style of the delegated asset managers, so that they can optimise the investment targets including performance targets in total.

Conclusion

It is estimated that there are currently more than 100 funds worldwide that use the name “Transition”, 70% of which are domiciled in Europe. Of the total assets under management of these “transition funds” totalling around €50bn, around 90% are invested in equity strategies, which show a mixed performance picture for 2023.¹⁶

The Climate Transition equity methodology presented here illustrates a way for institutional investors to achieve climate and performance targets sustainably.

This transition equity methodology aims to avoid potential sources of performance losses and risk increases compared to the investment benchmark.

In principle, the approach presented is scalable and adaptable to all equity investment universes used by an asset owner, as well as to the corporate bond segment.

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References

- ¹ Source: [Members – United Nations Environment – Finance Initiative](#) as at 8 January 2025.
- ² Source: [NZAOA Target-Setting Protocol Fourth Edition – United Nations Environment – Finance Initiative](#).
- ³ Source: GDV, Nachhaltigkeit und Net-Zero-Commitments in der deutschen Versicherungswirtschaft, Asset Owner und Assetmanager im Gespräch – Net-Zero-Commitments von Investoren, 1 October 2024.
- ⁴ Source: UN-convened Net-Zero Asset Owner Alliance, Demonstrating 1.5°C-Aligned Decarbonisation, The fourth progress report, October 2024, p. 14.
- ⁵ Source: Absolut I Impact, Issue #01/2024, Impact of CO₂ reduction targets on equity portfolios, C. Jasperneite and R. Haller, M.M. Warburg, pp. 21–23
- ⁶ Source: [COMMISSION DELEGATED REGULATION \(EU\) 2020/1818 of 17 July 2020 supplementing Regulation \(EU\) 2016/1011 of the European Parliament and of the Council as regards minimum standards for EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks](#).
- ⁷ Source: Munich Re Investment Partners Calculations based on: EDGAR (Emissions Database for Global Atmospheric Research) Community GHG Database (a collaboration between the European Commission, Joint Research Centre (JRC), the International Energy Agency (IEA), and comprising IEA-EDGAR CO₂, EDGAR CH₄, EDGAR N₂O, EDGAR F-GASES version EDGAR_2024_GHG (2024) European Commission.
- ⁸ Sources: [SBTi Passes 10,000 Companies Committing to Science-Based Climate Targets – ESG Today](#). About SBTi: How it works – Science Based Targets Initiative
- ⁹ Source: [see for example this study by the Centre for Economic Policy Research \(CEPR\): Pricing climate transition risk in Europe’s equity market | CEPR](#).
- ¹⁰ Sources: [Climate Analytics | ISS](#), Climate data and metrics – MSCI, JP Morgan – The Carbon Transition Score, Climate Transition an Accelerating Threat to Corporate Futures | BloombergNEF.
- ¹¹ Source: [Fliegel, Philip, How you measure transition risk matters: Comparing and evaluating climate transition risk metrics \(January 31, 2024\). Available at SSRN](#).
- ¹² Sources: [TPI’s methodology report: Management Quality and Carbon Performance, Version 5.0, November 2023](#), Climate Action 100+ – Methodologies – Company Net Zero Standards, SBTi’s Corporate Net Zero Standard, [IIGCC – Investor Expectations of Corporate Transition Plans: From A to Zero](#).
- ¹³ Source: [GFANZ \(2022\) – Measuring Portfolio Alignment “ ENHANCEMENT, CONVERGENCE, AND ADOPTION”](#).
- ¹⁴ Source: [NGFS](#).
- ¹⁵ Note: It should be emphasised that the calculation is company-specific, but the interpretation makes a global statement about how much the global temperature would rise if the world economy as a whole were to exceed or fall short of its CO₂ budget in this way.
- ¹⁶ Source: [Olive Is the New Black: The Rise of Transition Funds – MSCI](#).