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Deborah Kidd and Bruno Bertocci

Climate change can impact portfolio assets in material and unexpected ways, both near-term and in the coming years, as the world attempts to mitigate this systemic risk.
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Navigating net-zero investing benchmarks, incentives and time horizons

A net-zero investment programme must carefully consider climate change risk while striving to achieve an asset owner's financial objectives

MANY asset owners are adopting net-zero objectives to manage their investment exposure to climate change risk. A net-zero investment objective aims to attain net-zero portfolio greenhouse gas (GHG) emissions by 2050, in line with the global goal of zero growth in real-world GHG emissions set by the Paris Agreement in 2015.

Strategies to achieve a net-zero investment objective typically include reducing portfolio emissions to lower transition risk, investing in climate change solutions to capitalise on macro trend opportunities, and using engagement and advocacy to reduce systemic risks.

Adding a net-zero objective to a traditional investment programme presents challenges for asset owners because they must grapple with balancing a net-zero objective with fiduciary duty responsibilities, setting climate risk policy, and how to benchmark net-zero investment strategies, incentivise managers, and determine performance horizons. In this article, we explore these issues and propose solutions.

Net-zero objectives

A net-zero objective must not compromise an asset owner's risk, return, and actuarial objectives. On the contrary, a well-executed net-zero investment programme can support the attainment of these objectives in line with fiduciary duty responsibilities. Portfolio decarbonisation and real-world decarbonisation are not ends in themselves, but rather means to an end – to protect and enhance a plan's assets.

The concept of fiduciary duty differs across geographies, but the duties to act with care and prudence apply universally. Net-zero investment programmes that carefully consider climate risk while striving to achieve an asset owner's financial risk and return objectives fit within these duties.

Climate risk policy

In a traditional investment programme, asset owners may measure investment risk as tracking error, volatility, value-at-risk, or another mean-variance risk metric. A net-zero investment programme requires risk measurement, too. Mean-variance analysis, however, fails to capture climate change risk because historical data is insufficient to predict how climate change risk could affect stock price behaviour.

Portfolio climate change risk is complex, with multiple contributing factors, including transition risks, physical risks, and systemic risks – risks that don't map to the factors in a mean-variance risk tool. Although GHG emissions are widely used as a proxy for climate risk, simply measuring and managing portfolio emissions does not fully account for climate change risk.

Additional transition risk factors that can be monitored include the existence of company science-based emissions reduction targets, transition plans, or capital expenditures on emissions reduction. Measuring the physical risk factors of companies is time-consuming and data-intensive; third-party databases can often provide good solutions.