S&P Dow Jones Indices
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A Matter of Degrees: Aligning ESG Strategies with the Paris Agreement

This piece appears in the Spring 2021 edition of Indexology Magazine.

Jaspreet Duhra
Senior Director
Head of EMEA ESG Indices
S&P Dow Jones Indices

Francois Millet
Managing Director
Head of Strategy, ESG, and Innovation
Lyxor ETFs

Having already witnessed some of the consequences of climate change around the world, more and more investors are now factoring ESG into their investment decisions. Enter the S&P PACT™ Indices (S&P Paris-Aligned & Climate Transition Indices), created to give market participants access to strategies designed to be compatible with limiting global warming to 1.5°C.

We talked with Francois Millet, Managing Director and Head of Strategy, ESG and Innovation at Lyxor ETF, and Jaspreet Duhra, Senior Director and Head of EMEA ESG Indices at S&P DJI, about the evolving role of ESG in mainstream investing and how these indices may help market participants envision a less fraught future.

Indexology Magazine: Why do you think ESG investing is becoming more important to investors around the world, and do you think the recommitment to climate initiatives in the U.S. adds to the momentum?

Francois: The pandemic triggered a realization that humans are extremely dependent on natural systems. Many investors now work on the widespread conviction that climate and exponential inequalities are major risks—and that mitigating these risks, and building a more inclusive and resilient world with long-term focus, is a precondition for financial stability.

ESG investments captured more than 50% of net inflows to ETFs in Europe last year.[1] This more than offset the negative influence of the official U.S. position on

[1]Source: Bloomberg, Lyxor International Asset Management. Data as at Jan. 8, 2021.

the Paris Agreement at the time. But it's great to see the U.S., which produces around 15% of the world's greenhouse gas emissions,[2] rejoining the Agreement. This recommitment to climate initiatives should bolster the ESG transformation that's already underway and make the Paris Agreement stronger than ever.

Indexology Magazine: Why were the S&P PACT Indices created, and what specific climate goals do they seek to achieve?

Jas: The world is on a dangerous trajectory of warming that is already impacting society and the economy. Regulators are taking action and as investors increasingly take stock of the climate risks in their holdings, more and more are looking to align their investments with a scenario in which warming increases by no more than 1.5°C. The S&P PACT Indices were created with this goal in mind.

The indices are designed to meet the minimum standards for EU Paris-aligned Benchmarks and EU Climate Transition Benchmarks, which means that in addition to lowering carbon emissions relative to their underlying benchmarks, the indices also seek to decarbonize on an absolute basis at a rate of 7% year-on-year. This is the rate of decarbonization required to achieve net-zero emissions by 2050 and limit warming

[2]Source: Global Carbon Atlas, http://www.globalcarbonatlas.org/en/CO2-emissions.

to 1.5°C according to the Intergovernmental Panel on Climate Change. Interestingly, these indices are also designed to maintain the same exposure to high-climate-impact sectors as their benchmarks, which means the decarbonization can't be achieved by just tipping all the weight into low-climate-impact sectors.

We have also gone beyond the EU Low Carbon Benchmark requirements by aligning with the recommendations of the TCFD (Taskforce on Climate-related Financial Disclosures). We believe that the TCFD approach of breaking climate issues into transition risks, physical risks, and opportunities provides a holistic assessment. It's particularly important that our index takes climate change's physical risks into account, as we already see these risks playing out today.

Indexology Magazine: What types of companies are excluded from the index and what types of companies are given extra weight?

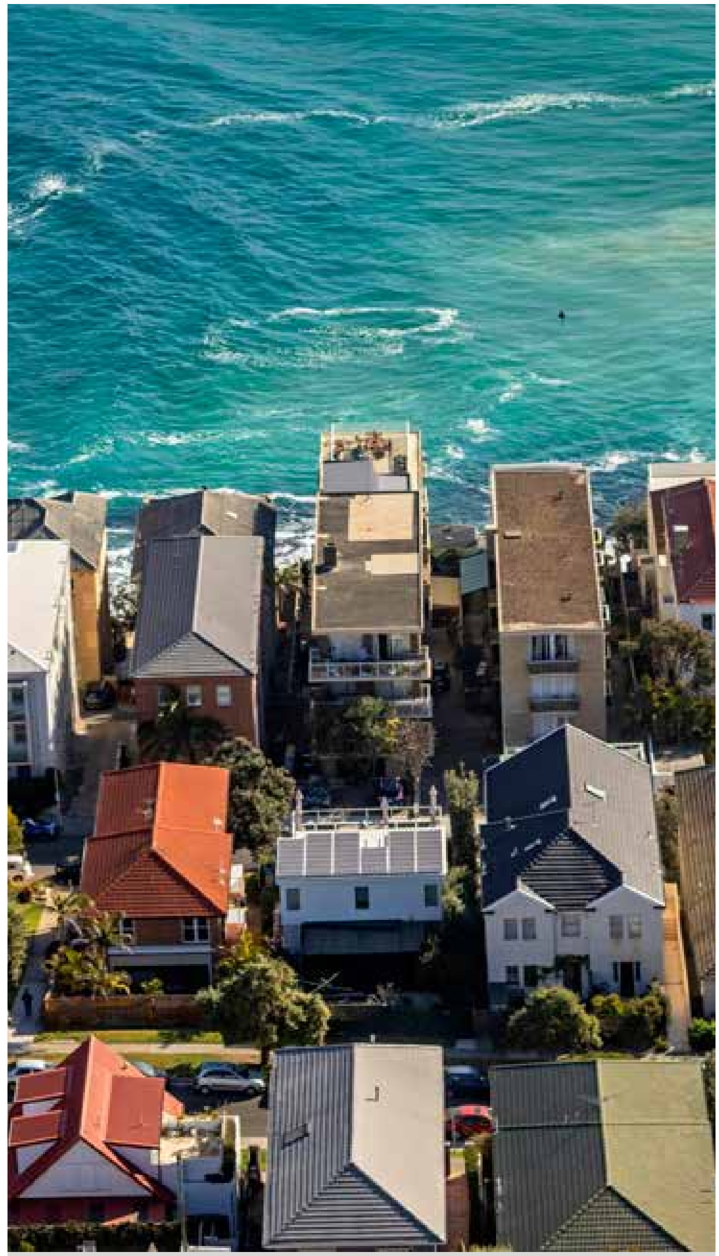
Jas: We have two index series under this umbrella: the S&P Paris-Aligned Climate Indices and the S&P Climate Transition Indices. The Paris-aligned indices are stricter and include a range of fossil fuel exclusions. Both sets of indices exclude companies involved in ESG controversies and problematic activities such as controversial weapons and tobacco, as well as companies with low UN Global Compact scores.

Broadly speaking, companies that perform well against the climate change constraints will be more heavily weighted in the indices. Factors that are particularly important include the companies' environmental score, their predicted alignment with a 1.5°C scenario, and their exposure to physical risks.

You can find the complete methodology and more information about the indices here.

Indexology Magazine: How would you respond to someone who might be a bit wary of deviating too far from the market by investing in ESG?

Francois: Our investors are often surprised that the "cost" of aligning their portfolio to the 1.5°C scenario is relatively moderate, in terms of deviation from the market. Based on back-tested data, we see a



tracking error of less than 2% (over three years) for U.S. or developed world equities with the S&P Paris-Aligned Climate Indices, and a bit more for Europe. This tracking error turned out to produce positive tracking difference over the last three years.[3]

There are also portfolio construction techniques that are designed to achieve the lowest-possible deviation vis-à- vis the benchmark index. The index methodology adopted by S&P DJI relies on an optimization concept,

[3]Source: S&P Dow Jones Indices, MSCI, Bloomberg LP, Lyxor International Asset Management. Data as at Dec. 31, 2020. Past performance is not a reliable indicator of future performance.

which we feel is the best way to accommodate the multiple constraints required for portfolio temperature alignment when tracking this type of index.

Indexology Magazine: What impact, if any, do you think promoting the 1.5°C alignment could have on corporate culture and our ability to ultimately achieve net-zero emissions by 2050?

Francois: We see no other option but to set our portfolios on an absolute decarbonization pathway. By significantly reallocating capital in favor of companies that are the most successful in reducing their emissions, while penalizing laggards and incentivizing them to catch up, investors in climate-aligned strategies send clear signals to corporates. We believe that adoption of climate-aligned strategies at scale will have a strong leverage on the listed economy, which is responsible for close to 50% of global greenhouses gas emissions—and more through their supply chain.

Indexology Magazine: What do you think the ESG investing landscape may look like 10 years from now?

Francois: It will likely take less than 10 years for ESG investing to become the new normal. Better corporate disclosure combined with enhanced standards and data will make ESG ratings as important as credit ratings in a global corporate assessment. We could potentially see the implied temperature rise of companies or portfolios becoming a new standard market data point, just like P/E or EPS. There may be a tipping point where staying on the wrong side of the market—in terms of ESG rating, exposure to climate transition risks, physical risks, and under-exposure to opportunities—would be more costly. Some asset owners in Europe are starting to switch their whole "policy benchmark" to ESG or climate-aligned benchmarks. This could be a window into the future landscape of investing. ■

PERFORMANCE DISCLOSURE

The S&P 500 Paris-Aligned Climate Index and the S&P Developed Ex-Korea LargeMidCap Paris-Aligned Climate Index were launched June 1, 2020. The S&P Europe LargeMidCap Paris-Aligned Climate Index was launched May 4, 2020. The S&P Eurozone LargeMidCap Paris-Aligned Climate Index was launched April 20, 2020. All information presented prior to an index's Launch Date is hypothetical (back-tested), not actual performance. The back-test calculations are based on the same methodology that was in effect on the index Launch Date. However, when creating back-tested history for periods of market anomalies or other periods that do not reflect the general current market environment, index methodology rules may be relaxed to capture a large enough universe of securities to simulate the target market the index is designed to measure or strategy the index is designed to capture. For example, market capitalization and liquidity thresholds may be reduced. Complete index methodology details are available at www.spglobal.com/spdji. Past performance of the Index is not an indication of future results. Back-tested performance reflects application of an index methodology and selection of index constituents with the benefit of hindsight and knowledge of factors that may have positively affected its performance, cannot account for all financial risk that may affect results and may be considered to reflect survivor/look ahead bias. Actual returns may differ significantly from, and be lower than, back-tested returns. Past performance is not an indication or guarantee of future results. Please refer to the methodology for the Index for more details about the index, including the manner in which it is rebalanced, the timing of such rebalancing, criteria for additions and deletions, as well as all index calculations. Back-tested performance is for use with institutions only; not for use with retail investors.

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