Screening for low emission portfolios. How to beat the benchmark.

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Overview

There's no shying away from the fact of the sheer complexity of the emissions landscape.

That's why we've written this Insight Briefing: to guide investors so that they can maintain a global balanced portfolio while achieving lower emissions than major benchmarks *and at the same time,* aligning their portfolios to decarbonisation pathways.

This Insight Briefing outlines the results of our screening analysis across the Urgentem emissions data universe using Scope 1&2 and Scope 1,2&3 tests.

The results will surprise many investors because they challenge many unquestioned assumptions and generalisations about sectoral emissions performance in addition to highlighting new opportunities in areas that have hitherto been overlooked.

Introduction

In recent conversations about portfolio climate risk analysis, customers have noted that some companies which easily pass a Scope 1 & 2 screening, can just as easily fail at the Scope 3 hurdle.

While this is not surprising (given that Scope 3 emissions represent, on average 85 per cent of total emissions) our analysis revealed some interesting results with several sectors struggling to pass the Scope 3 test, while other sectors come out more favourably, relative to benchmarks, once Scope 3 is taken into account.

Adding a Scope 3 lens to a portfolio screening process can produce results that are not quite as clear cut as a summary analysis would suggest. In fact, our findings *highlight the importance of taking the distribution of emissions between the Scopes into account.* This also raises serious questions about where to set the parameters for screening across the different emissions Scopes.

Overall, we find further evidence supporting the inclusion of Scope 3 analysis when constructing low emissions portfolios. Without the inclusion of Scope 3 screening, investors' portfolios may fail to live up to low emission standards. Moreover, and even more concerning, they can fail to match emission benchmarks. Finally, there's the equally worrying possibility that significant opportunities could also be missed.

Setting the bar

Given the lack of a standard definition for a low emissions portfolio, opinions differ with regards to where to set the bar for this type of screening exercise. For the purposes of our analysis, we tested various methods including using fixed emissions limits and percentile measures, before opting for using a benchmark index against which to screen our emissions data universe.

After testing across a variety of indices, we decided on the MSCI ACWI as the benchmark, given its representation of a global balanced portfolio.

For the initial screening we set a cap on Scope 1&2 emission intensity (by revenue) aligned with the MSCI ACWI. For the second screening an additional cap was set for the inclusion of Scope 3, again in alignment with the MSCI ACWI. While this may be viewed as an undemanding test, given the MSCI ACWI is not considered a low emissions benchmark, it offers an excellent example because *it demonstrates the importance of understanding the underlying emissions data*.

Sector Level View

Taking an initial sector level view, it is interesting to note that the majority of sectors have a lower average level of carbon intensity (by revenue) than our benchmark index (MSCI ACWI), when just Scope 1&2 are considered (see Figure 1 &2).

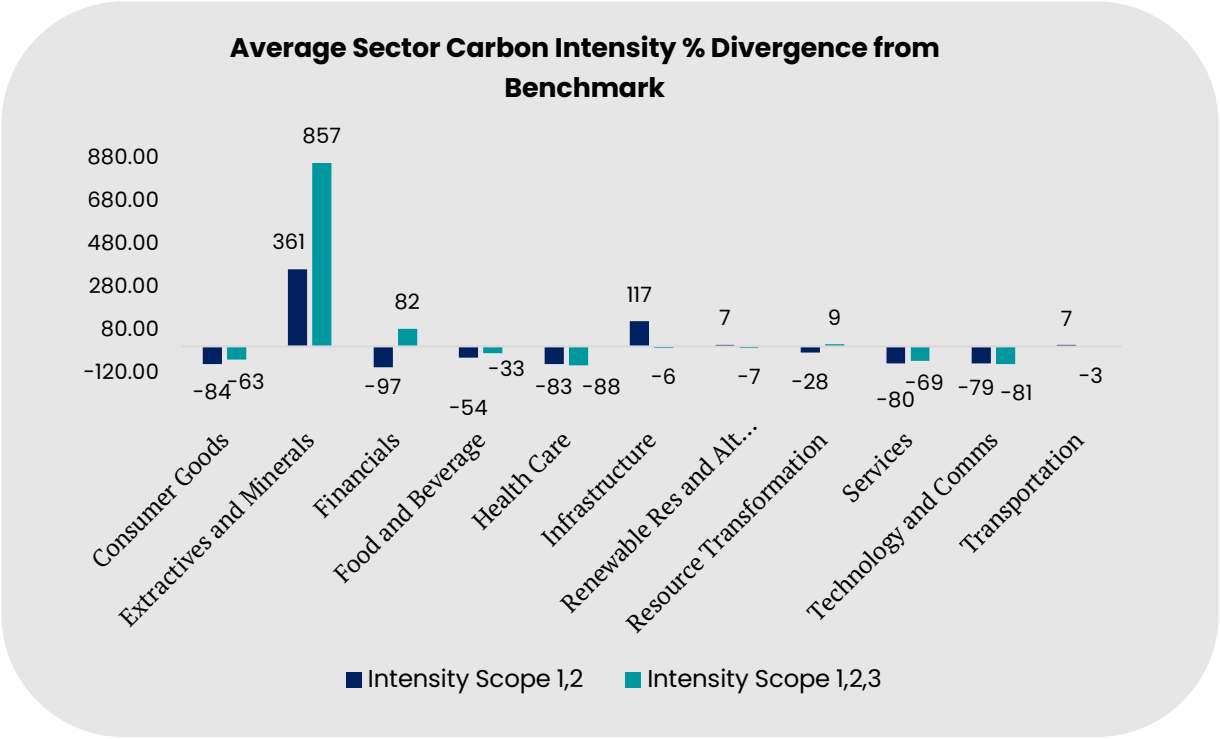

Figure 1: Average Sector Carbon Intensity, percentage divergence from benchmark

Source: Urgentem

Few will be surprised when we reveal that Extractives and Mineral Processing, Infrastructure and Transportation are the sectors that fail to make the mark in this initial test. However, interestingly, the Renewable Resources and Alternative Energy sector also falls into this category, when the SASB sector classification is used, missing the mark by a relatively slim margin of 7%.

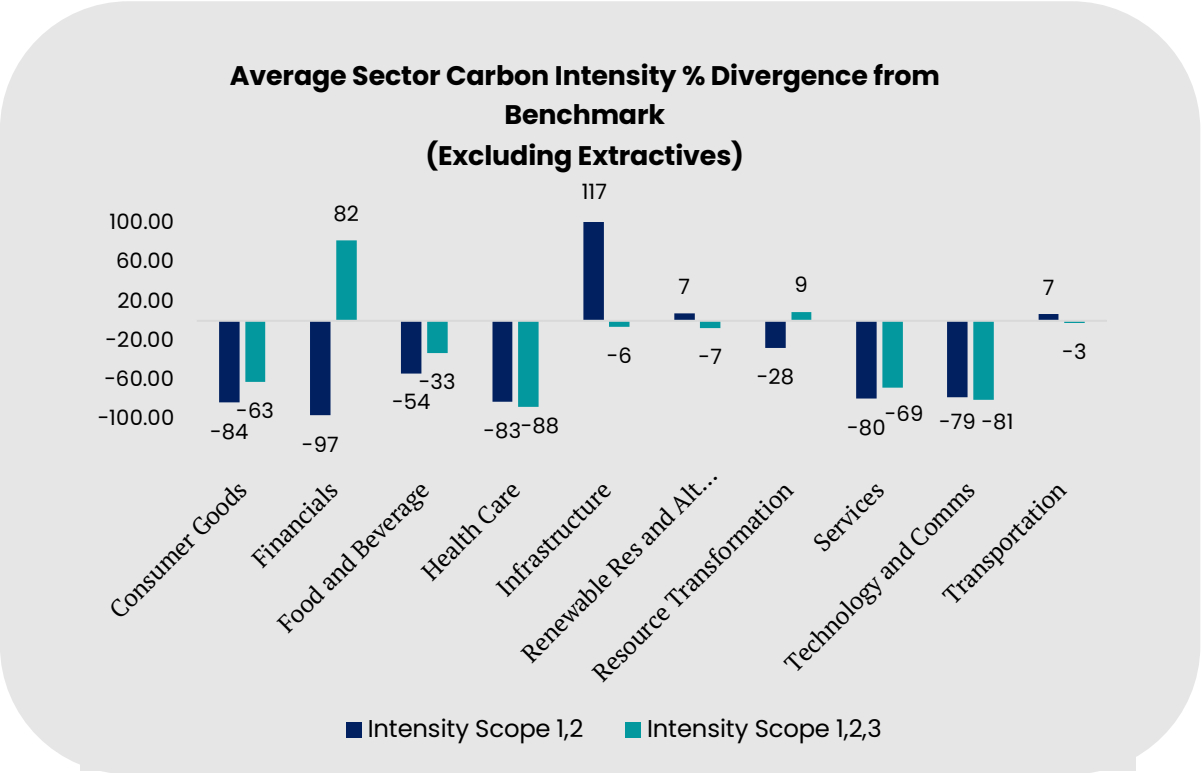

Figure 2: Average Sector Carbon Intensity, percentage divergence from benchmark (Excluding extractives)

Source: Urgentem

When Scope 3 emissions are included in the equation, the average emissions intensity of yet another sector also exceeds the Scope 1,2&3 emissions intensity of our benchmark. This is the Financials sector. However, two sectors which previously missed the mark under the Scope 1&2 screening are found to be back on the right side of the benchmark once average Scope 3 intensity is considered. These are the Renewable Resources and Alternative Energy sectors and the Transportation sector. In this example, it is the Transportation sector that just makes it in, barely scraping by.

Stock Selection remains key

Taking a deeper dive into the sector level analysis we find that there are three sectors passing our emissions screening process with flying colours, with all companies evidencing lower emissions than our benchmark for both Scope 1&2 and Scope 1,2&3. These are the

Health Care, Services and Technology and Communications sectors (see Figure 3, next page).

At the other end of the scale, only 2% of companies in the Extractives and Minerals Processing sector could better our benchmark for Scope 1&2 Emissions, while not a single company passes the secondary Scope 1,2&3 test.

The sector which displays the largest changes in fortunes is Financials. While comfortably passing the Scope 1&2 screening at a sector level with all companies having lower emissions than our benchmark, the Financials sector fails once Scope 3 emissions come under scrutiny, with the number of companies having lower Scope 12&3 emissions than the MSCI ACWI falling to 69%.

Resource Transformation is yet another sector which passes our Scope 1&2 screening, but fails to make the mark when the scope 1,2&3 test is applied. Within the sector, 71% of companies have lower Scope 1&2 emission intensity than the benchmark, falling to 60% when Scope 3 emissions are added into the equation.

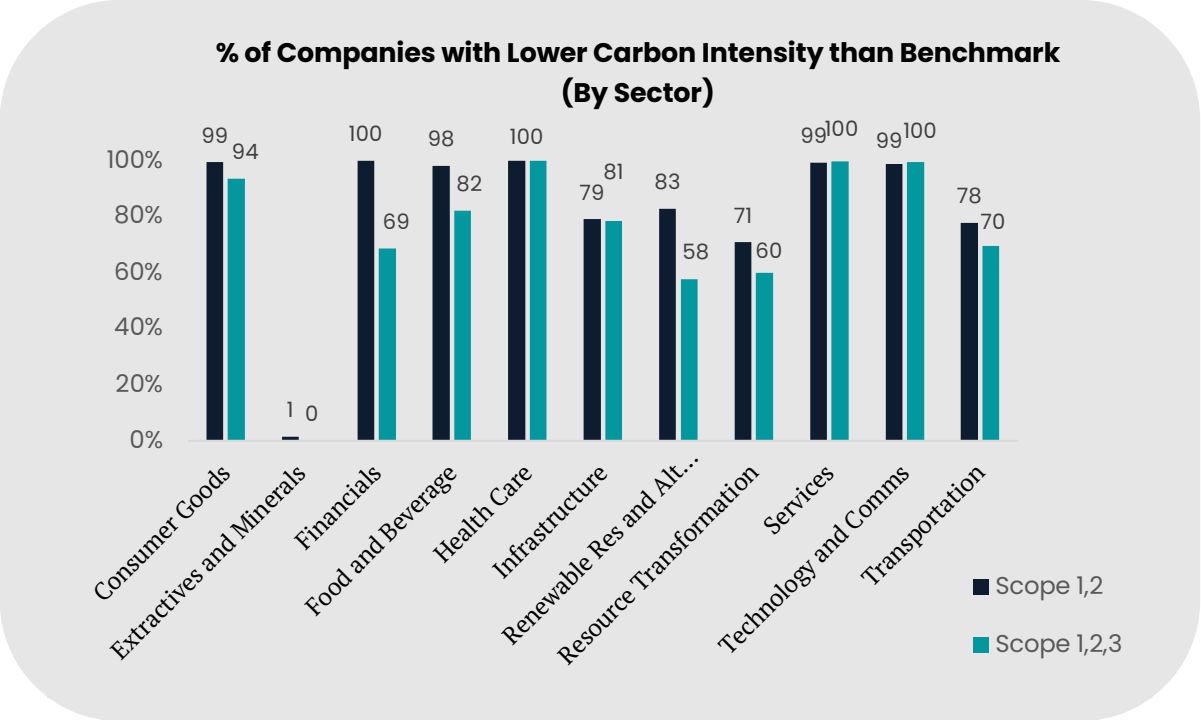

Figure 3: Percentage of companies with lower carbon intensities than benchmark, by sector
Source: Urgentem

Renewables Surprises

As highlighted earlier, the Renewable Resources and Alternative Energy sector gives us *the biggest surprise*. In fact, the surprises keep on coming as we dive deeper into the underlying data. Despite the sector just missing out on matching the benchmark for Scope 1&2 average emission intensity, *83% of companies in the sector evidence a lower intensity*

score. Under the Scope 1,2&3 examination, the sector intensity comes in just under the limit set by our benchmark, but this is achieved with fewer companies, just 60% passing the mark.

The results recorded by the Renewable Resources and Alternative Energy are the result of the diversification of companies under this particular SASB classification with a wide range of emission intensities.

Conclusion

Overall, the results of this simple screening exercise highlight the importance of including Scope 3 emissions in analysis as this has the potential to dramatically change the climate risk profile of portfolios, impacting alignment to benchmarks and climate scenarios.

Finally, we urge all attentive investors to commit to memory an important, positive takeaway.

With careful stock selection, a global balanced portfolio can be constructed which not only represents most sectors, but also has a lower carbon footprint than many major global benchmarks and aligns to climate scenarios.

How can we help?

Urgentem's data and Element6™ Climate Risk Platform: info@urgentem.net
Book an Element6™ demo: demo@urgentem.net
More information can be found at www.urgentem.net