

Innovation conversations



Date: 30 November 2021

Topic: Innovations in managing climate transition risk

Participants:

Piers Lowson – Baillie Gifford
Herschel Pant – AXA IM
Bruno Bamberger – AXA IM
Nikolaus Silem – Quoniam AM
Zachary May – IFM Investors
Debbie Harris – Abrdn
Carlos Rudolph – Quoniam AM
Nigel Cresswell – Quoniam AM
Emma Whiteacre – BlueBay AM
James Dodge – SPS DJI
Cristina Serrano – Santander Asset Management
Thomas Kieselstein – Quoniam AM
Kirsty Beasley – Alliance Bernstein

Edward Evers – Ninety One
Peter Scaturro – SPS DJI
Ravi Venkataraman – MFS
Arthur Grigoryants – RWC Partners
Susan Raynes – Allspring Global Investments
Nicolas Ebhardt – Quoniam AM
Eoin Murray – Federated Hermes
Cindy Thompson – Capital Group
Evan McEvoy – Allspring Global Investments
Craig Baker – Willis Towers Watson (WTW)
David Nelson – WTW
Marisa Hall – Thinking Ahead Institute (TAI)
Paul Deane-Williams – TAI
Ruth McDonald – TAI

Agenda

- Marisa Hall: Discussion framing – Asset owners (AO) challenge in integrating climate thinking, TCFD top-down considerations and six key metrics for a climate dashboard
- Craig Baker: What is Climate Transition Value at Risk (CTVaR)?
- David Nelson: Innovations in climate metrics and CTVaR
- Freeform discussion and wrap-up

Discussion framing

- Marisa started the conversation by outlining how climate change is impacting AOs, and what the portfolio opportunity looks like. Systemic risks (unhedgeable and undiversifiable) are increasingly a factor in our future. But policy responses are adapting slowly and climate data is maturing unevenly

Measurement

- Climate metrics are challenging. Factors include system transition (free-rider opportunities), mandate changes, stewardship, climate solutions and de-risking
- Transition risk is a significant component because it represents a financial risk for AOs

CTVaR measures climate transition risk

- Decarbonisation metrics are only partially useful in relation to real-world outcomes. (e.g. they could prevent investment in carbon-intensive climate solutions). There is very little correlation between carbon footprint and financial risk
- CTVaR measures the value lost (or gained) during the transition to a low-carbon economy and is the methodology used behind the Climate Transition Index (CTI).
- **How CTI works:**
 - Uses data already available to portfolio managers and equity analysts (e.g. financial statements, asset level capex and operating costs, commodity and product supply curves, product margins, sector level competition models, and emissions levels including scope 3)
 - Measures what would happen to different commodities and companies under different climate-transition scenarios; then the difference between current market value and projected value under each scenario, based on the present value of free cash flows that underpin a company valuation
 - A simple, low-cost approach based on assets and strategies currently in place; not potential options in the future
- **Benefits:**
 - Allows governments, corporates, asset managers, investors and society to work together in a more consistent way
 - Goes beyond carbon footprint and expected change in carbon price
 - It assesses forward-looking company transition risk, rather than using historic carbon emissions data
 - CTI focuses on the wide range of changes needed at the systems level in order to drive down GHG emissions consistent with the goals of the Paris Agreement
- **Uses:**
 - Prices in transition risk
 - Challenges active managers
 - Helps companies plan for the climate transition

Round table discussion

- Can you make portfolio-level decisions without full data coverage?
 - The CTI index covers over 7000 corporates, including analysis of individual oil fields, coal mines, and other fossil fuel assets. As of December, beyond the largest 2500 corporates, machine learning compares companies business segments, geographic and carbon footprints, and financial metrics and their evolution to provide an estimated CTVaR for the remaining companies. The number of companies under direct coverage is increasing every month and represents over 85% of global index market cap
 - Fixed income – 85% of companies have no credit risk; the risk for those that do is highly dependent on maturity (significant for 7+ years) and/or highly levered; thus, long dated fixed income for highly levered companies with high transition risk is most exposed
 - Sovereigns with high credit risk will need more support from the IMF to transition and therefore might justifiably be excluded from net zero metrics to avoid starving investment to countries that most need the investment to make a transition
- Does the index allow for companies making changes?
 - This is a passive product to show what risk is priced in. It assumes a below 2°C scenario, and what companies are doing – not pledges or options. But active managers can use this a basis to engage with companies to understand the credibility of future plans.

- Is it a challenge to source data from some companies?
 - All data required is already used by asset managers. Carbon footprint is only a small component. Data is around specific assets e.g. individual oil fields/mines, products
 - Scenarios for each business segment of commodity are based on the work of international and governmental organizations, academics, think tanks, sell side, etc.
 - Models are based on expert analysis from academics, consultants and NGOs (e.g. analysis on the semiconductor industry for electric cars)
 - Any asset manager could do this in theory but getting set up is time consuming. This work began in 2012

- As with smart beta, does this become the new market cap if everything transitions?
 - Potentially – A happy outcome would be that the transition had occurred and was fully priced in, so that all asset prices reflected the reality of the transition having occurred. In that case there would be no more climate transition problem to solve.
 - While the transition may be priced in more quickly to equity markets, the methodology will likely continue to be helpful across asset classes, as we see transition risk increasingly moving from equity markets to fixed income, private, and sovereign markets. New products and different indices are being developed to address these markets going forward

- How does this help asset owners (AOs) who are time poor and need to report against existing frameworks?
 - Encouragement for TCFD reporting regulations to include metrics like CTVaR
 - Can be used internally to measure risk
 - It was included as an option within the six CFRF metrics. The CFRF framework will weigh the importance of the six different metrics differently through time. E.g. transition risk is most important now but carbon footprint is important long-term
 - The Bank of England is currently considering whether to regulate CTVaR. Discussions with regulator are ongoing – aim is to prevent simplification to short-term portfolio decarbonisation
 - AOs see that this has more real world impact than carbon pricing

- How does this fit within WTW's business?
 - David's climate transition analytics team have built the tools and operate separately from WTW's investment business. They can work with AMs to build similar tools if of interest

- This also has applications for credit portfolios/private infrastructure debt

- What would WTW like to see managers doing?
 - More products in climate solutions – mobilising transition finance and including venture capital, infrastructure and other real assets. (More is available in private markets and equities than public space and fixed income)
 - Managers don't need to use CTVaR, but it is a useful tool for WTW to challenge managers
 - Diversity – hiring from other industries, e.g. energy

Wrap up

- We must get better at measuring, and quickly – increased standardisation is needed.
- Better engagement is needed but measurement is hard to define. All models are wrong but some are useful.
- CTVaR improves transparency and pricing. The challenge is communicating the benefits in a way that investors can understand. To move on, we need more consensus around climate-change metrics.

Appendix

Polling results

1. The major issues that I am experiencing with most climate metrics are... (select all that apply)

- None of them are financial based, making it difficult to square with fiduciary duty – 11%
- **They typically encourage simple portfolio decarbonisation, which is actually unhelpful for the transition required – 56%**
- **Most metrics to not fully account for the full system-wide impact – 67%**
- There are issues with double-counting and non-additivity due to Scope 1,2 and 3 emissions – 44%
- Other – 17%

(18 responses)

2. What is your most important climate transition investment need - today?

- TCFD compliance, reporting and regulation – 50%
- Portfolio screening for reputational risk and potential investment 'red flags' – 31%
- **Transition risk management – Mitigating the risk of portfolio underperformance due to economic transition – 56%**
- Investing in the transition as a source of outperformance – 50%
- Other/don't know – 6%

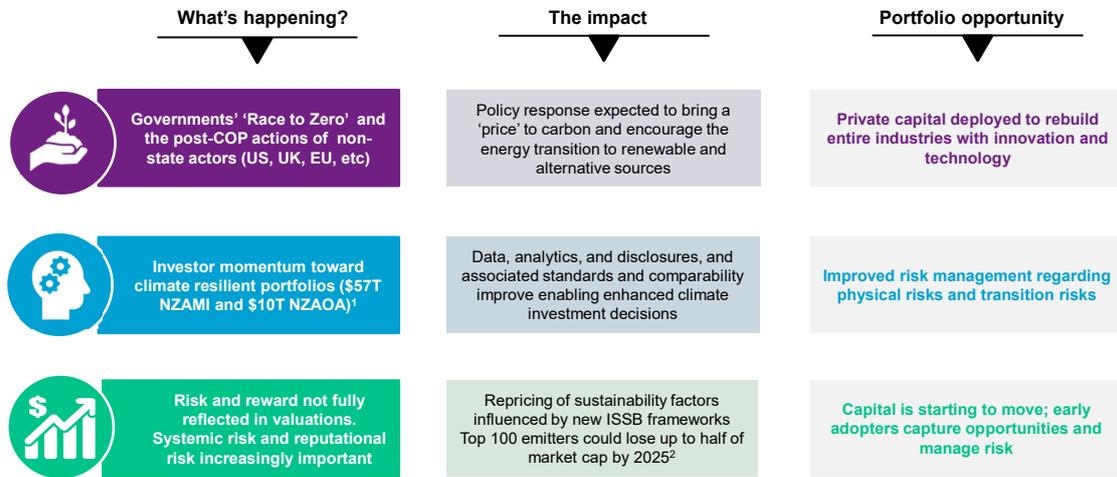
(16 responses)

3. What will your most important climate transition investment need be in 1-3 years?

- TCFD compliance, reporting and regulation – 20%
- Portfolio screening for reputational risk and potential investment 'red flags' – 20%
- **Transition risk management – Mitigating the risk of portfolio underperformance due to economic transition – 60%**
- **Investing in the transition as a source of outperformance – 70%**
- Other/don't know – 0%

(10 responses)

The case to integrate climate thinking into every part of the process



Source: Net Zero Managers Initiative and Net Zero Asset Owners Alliance as at November 2021¹, UN PRI²

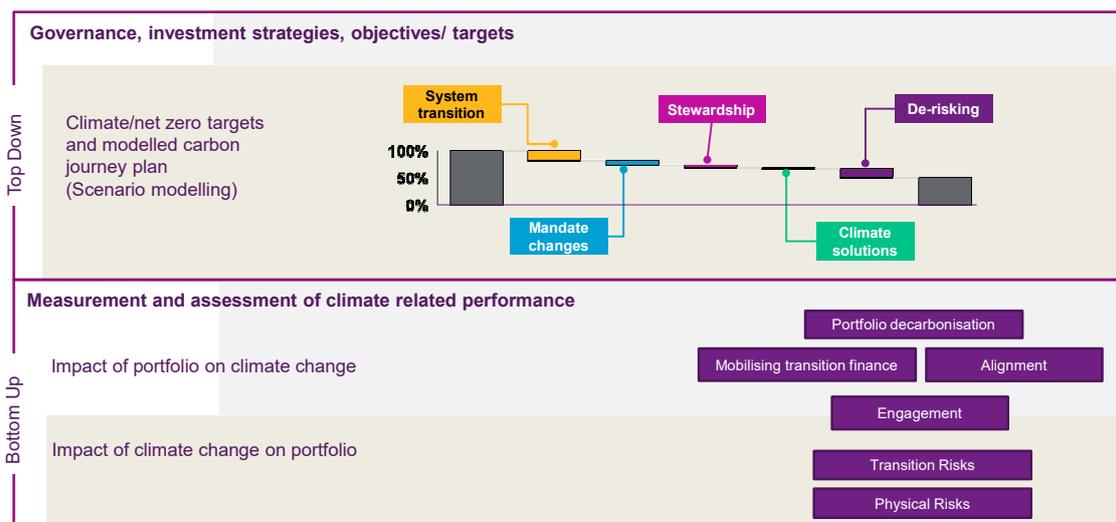
willistowerswatson.com
© 2021 Willis Towers Watson. All rights reserved. Proprietary and Confidential. For Willis Towers Watson and Willis Towers Watson client use only.

Willis Towers Watson 

1

1

How the reporting framework can develop



willistowerswatson.com
© 2021 Willis Towers Watson. All rights reserved. Proprietary and Confidential. For Willis Towers Watson and Willis Towers Watson client use only.

Willis Towers Watson 

2

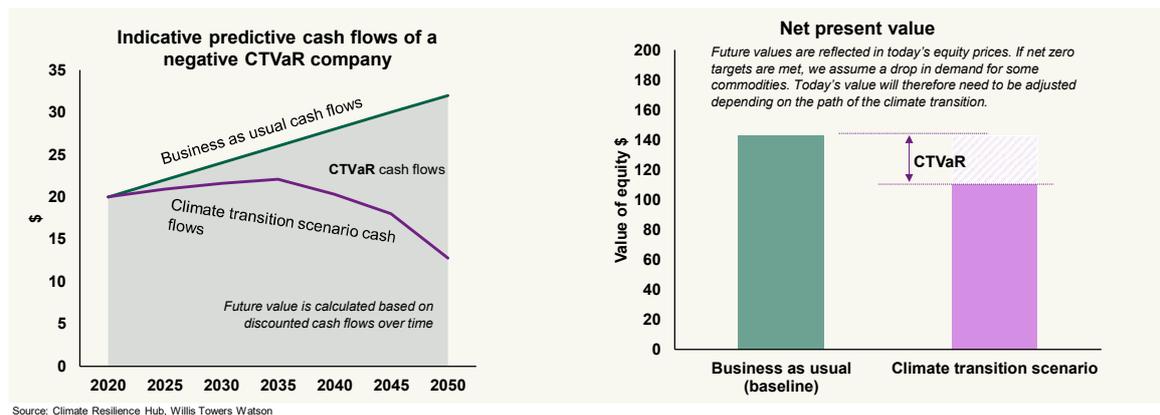
2

Climate Transition Value at Risk (CTVaR)

The measurement of the value lost (or gained) during the transition to a low-carbon economy

Ability to help:

- **Governments** better assess where the climate transition risks are in their economy
- **Corporates** better understand and manage their own risks from the transition
- **Asset managers** better analyse the transition risks of each of their investments
- **Investors** reduce portfolio risks and capitalise on opportunities via the CTI
- **Society** benefit from all of the actions resulting from the above



willistowerswatson.com
© 2021 Willis Towers Watson. All rights reserved. Proprietary and Confidential. For Willis Towers Watson and Willis Towers Watson client use only.

Willis Towers Watson

3

3

Climate Index (CTI)

How does the CTI help with a net zero commitment?



The CTI captures our latest thinking and research in helping investors manage climate-related risk

- Even where equities are a small part of the total assets, they can be a large part of the carbon footprint
- CTI reduces carbon emissions metrics immediately, but importantly only does so where it makes financial sense, linking with fiduciary duty in all markets
- It is forward-looking, so helps on the future pathway to net zero rather than simply at a single point in time
- There is a need to act quickly as these risks could be re-priced overnight
- It is simple (investing in a single fund with low tracking error to the market cap index)
- It is low cost

willistowerswatson.com
© 2021 Willis Towers Watson. All rights reserved. Proprietary and Confidential. For Willis Towers Watson and Willis Towers Watson client use only.

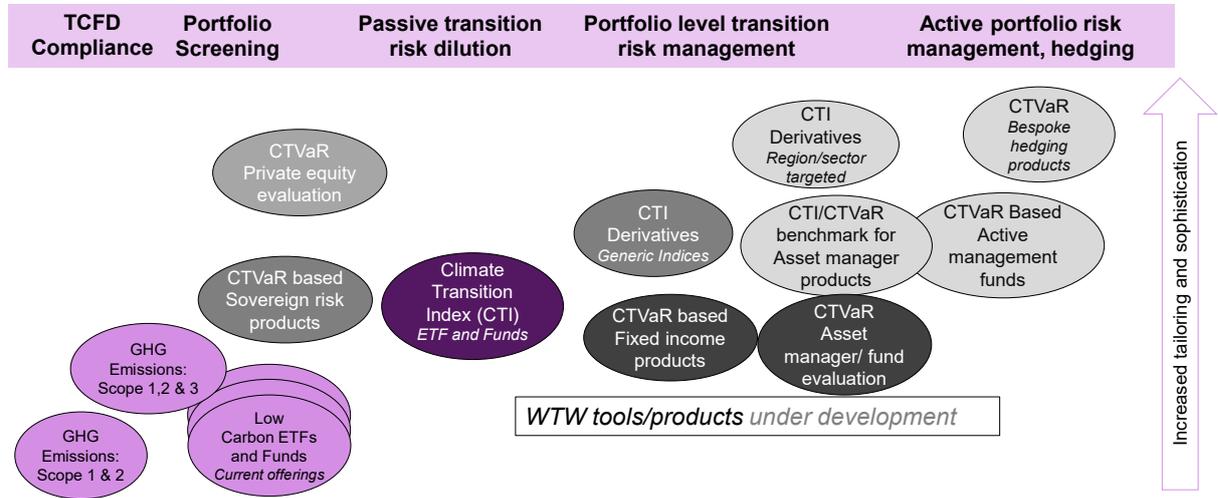
Willis Towers Watson

4

4

Innovations in managing climate transition risk

What is the objective?: Transition risk management application



About the Thinking Ahead Institute

The [Thinking Ahead Institute](#) is a global not-for-profit member organisation whose aim is to influence change in the investment world for the benefit of savers. The Institute's members comprise asset owners, investment managers and other groups that are motivated to influence the industry for the good of savers worldwide. It has over 50 members with combined responsibility for over US\$12 trillion and is an outgrowth of Willis Towers Watson Investments' Thinking Ahead Group.