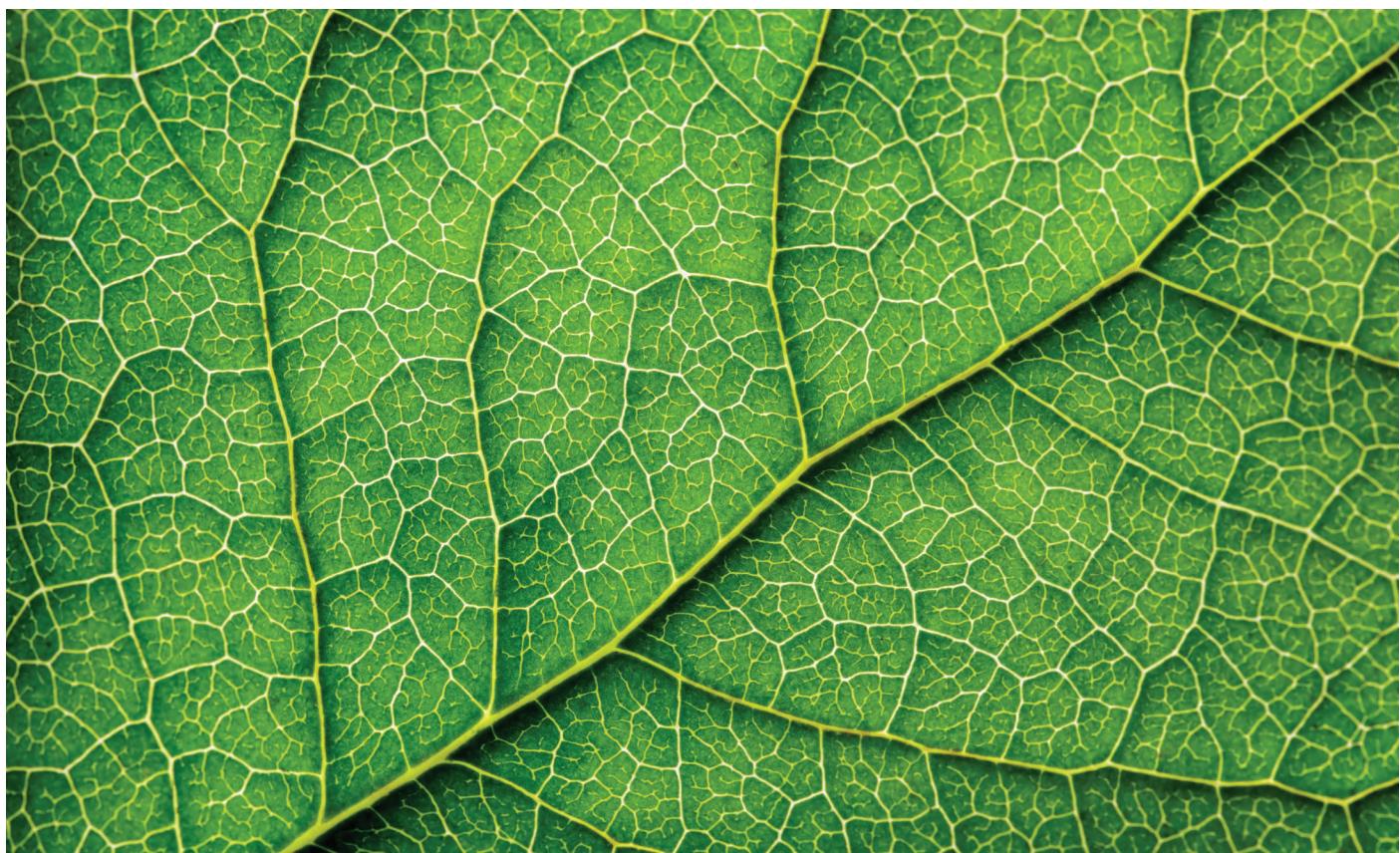


ESG Data Signals

The Trucost EU Taxonomy Revenue Share Dataset



Highlights

- Using Trucost's EU Taxonomy Revenue Share dataset, investors can calculate the proportion of a company's "green" revenues that have the potential to contribute to the low carbon transition.
- Constructing a "Green" & "Brown" portfolio with a green revenue percentage factor derived from Trucost's EU Taxonomy Revenue Share dataset results in an average spread between the Green and Brown portfolio over the time period of just -3bps, which is statically equivalent to zero.
- Within equities that have exposure to green revenue of greater than 1%, the equities with the highest exposure (Quintile 1) outperform those with the lowest (Quintile 5) by 2.62% on average annually.

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The EU Taxonomy for Sustainable Activities

In March 2018, the European Commission adopted an action plan on sustainable finance as part of a strategy to integrate environmental, social and governance considerations into its financial policy framework and mobilize finance for sustainable growth. In May 2018, the Commission released the first legislative package under the action plan and established a Technical Expert Group on Sustainable Finance (TEG) to inform its development. One of the proposals under the legislative package was the development of a unified EU classification system or 'EU Taxonomy' ('Taxonomy') that would define which economic activities are environmentally sustainable. In March 2020, the TEG published its final report outlining its recommendations on the design and implementation of the Taxonomy.

A tool to navigate the low carbon transition

The Taxonomy is essentially a tool that will help companies and investors navigate the transition to a low-carbon, resilient and resource-efficient economy. It sets performance thresholds for economic activities that make a substantive contribution to one of six key environmental objectives (outlined in Table 1 below), do not negatively affect the other five and meet minimum safeguards.

Enhanced disclosure requirements for financial market participants

To date, the Taxonomy considers economic activities that contribute to climate change mitigation and/or adaptation objectives by outlining 67 business activities that are linked to seven NACE¹ macro sectors. The TEG is planning to address the other environmental objectives in future iterations. Financial market participants offering financial products in the EU will be required to complete their first set of disclosures using the Taxonomy, covering climate change mitigation and/or adaptation, by the end of 2021. Companies will be required to disclose in the course of 2022.

For financial market participants, disclosures should be made as part of pre-contractual and periodic reporting requirements. For companies, disclosures should be made as part of the non-financial statement, which may be located in annual reporting or in a dedicated sustainability report.

The Taxonomy is one of the most significant developments in sustainable finance and may have wide-ranging implications for financial institutions (notably pension funds, insurers, banks and asset managers) and issuers working in the EU, and beyond.

Table 1: Six environmental objectives of the Taxonomy

1	Climate change mitigation	4	Transition to a circular economy
2	Climate change adaptation	5	Pollution prevention and control
3	Sustainable and protection of water and marine resources	6	Protection and restoration of biodiversity and ecosystems

Source: EU Taxonomy: Final Report on the Technical Expert Group on Sustainable Finance, March 2020

¹ NACE (Nomenclature des Activités Économiques dans la Communauté Européenne) is a European industry standard classification system of economic activities adopted by the TEG.

Trucost's EU Taxonomy Revenue Share Dataset

Trucost's EU Taxonomy Revenue Share dataset provides an assessment of the proportion of company revenues linked to the business activities outlined in the Taxonomy. The dataset covers 15,000+ listed companies representing 98% of global market capitalization, in Trucost's Core Plus universe including company revenue data going back to 2005.

Trucost uses a blended approach to assess the alignment of company revenues with the Taxonomy. Firstly, Trucost has conducted a direct mapping between the 464 business activities in its proprietary sector classification system with the 67 business activities mentioned above. The Trucost proprietary sector classification system is based on the North American Industry Classification System (NAICS), which is similar to the European NACE system.

Any business activities not mapped directly through this process are reviewed using a bottom-up assessment of their alignment with the objectives of the Taxonomy. During this step, Trucost reviews company reported revenues and emissions data from its Core Plus universe to verify that only business activities that have a carbon mitigation and/or adaptation potential are included in the dataset. Any business activities remaining after this step are not considered to be aligned with the Taxonomy.

Creation of a Green Revenue Factor

Using Trucost's EU Taxonomy Revenue Share dataset, investors can calculate the proportion of company revenues that have the potential to contribute to the low carbon transition. With a binary flag on the alignment of business activities with the Taxonomy, it is possible to aggregate the percentage of 'green revenue' for each company. For example, American Electric Power Co (AEP)² currently has 12.9% of its revenue stream from activities that align with the Taxonomy.

This 'Green Revenue Factor' can now serve multiple purposes, including:



Identifying companies that are best placed for the low carbon transition



Back testing the Green Revenue Factor

² Trucost Data from S&P Global Market Intelligence, Period End Date Dec 2018.

Factor Back Test

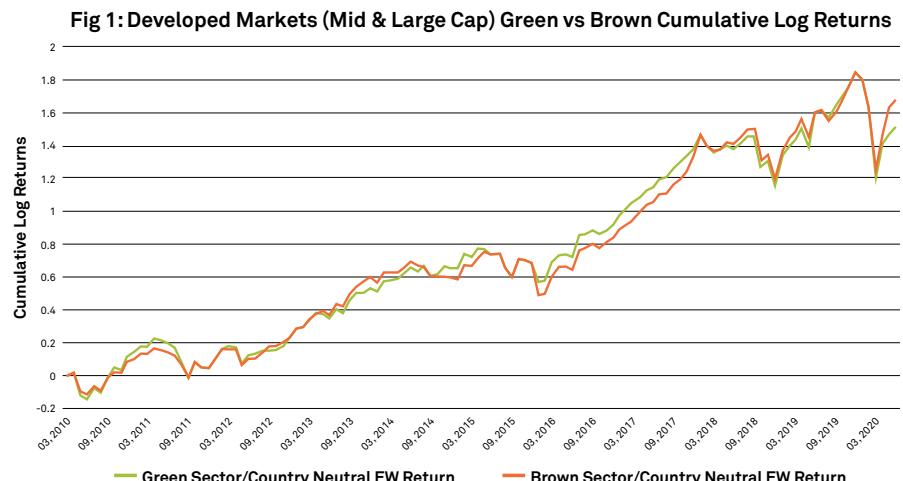
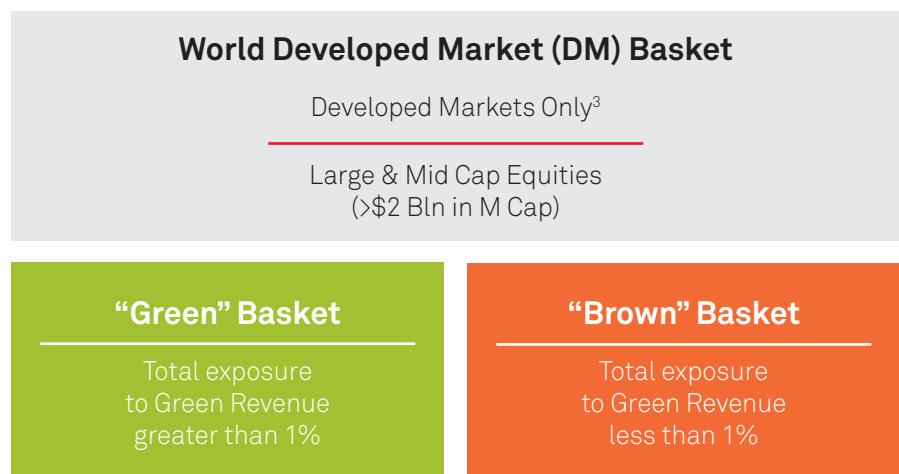
Is there any difference in the Top/Bottom return spread by actively investing in companies with exposure to green revenue? To test this hypotheses S&P Global Market Intelligence carried out a back test on the Green Revenue Factor.

We looked at the ~15,000 companies in Trucost's Core Plus Universe representing 98% of global market capitalization and created a developed market basket to test.

We then did a cross sectional split along the median of the Green Revenue % (~1%) to create a Brown basket and Green Basket:

“Green” & “Brown” portfolios were created by matching the country|sector exposures in the starting DM Large & Mid Cap basket that we created, equally weighting the constituents⁴ within the country-sector exposures and rebalancing monthly over the past 10 years.

The average spread between the Green and Brown portfolio over the time period is -3bps, which is statically equivalent to zero.⁵ Based on this analysis over the past 10 years the difference in the return spread in investing in equities with exposure to green revenue of greater than 1% and investing in brown equities (an exposure of green revenue less than 1%) was negligible.



Indices are unmanaged, statistical composites and their returns do not include the payment of any sales charges or fees an investor would pay to purchase the securities they represent. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.

Source: Trucost analysis. Current as at June 2020

³ Developed Markets – AUS, AUT, BEL, CAN, DNK, FIN, FRA, DEU, HKG, IRL, ISR, ITA, JPN, NLD, NZL, NOR, PRT, SGP, ESP, SWE, CHE, GBR and USA

⁴ Green & Brown portfolios were country/sector neutralized and rebalanced monthly. There was a binary flag into each portfolio (> 1% Green Revenue <). DM Basket Average Constituents ~2,400 (Average Green ~ 1,055/Average Brown ~1,258)

⁵ Green – Brown Average spread: -0.034%, std dev: 1.126% t = -.334, p 0.3694. Back tested performance has inherent limitations. The returns shown are hypothetical, do not represent the results of actual trading of investor assets, and are constructed with the benefit of hindsight. Thus, the performance shown does not reflect the impact that material economic and market factors had or might have had on decision making if actual investor money had been managed. Returns do not include payments of any sales charges or fees. Such costs would lower performance. Past performance is not a guarantee of future results.

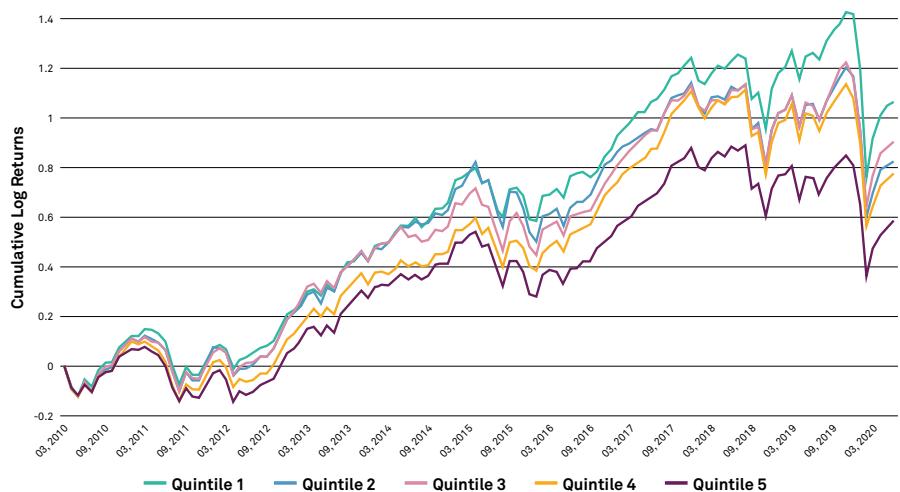
Developed Market “Green” Basket Back Test

After analyzing the return profile in green versus brown revenue equities and seeing no difference in the return profile, is there any outperformance/underperformance within green equities that exhibit higher/lower percentages of green revenue?

We ran a 10-Year Back Test just on the Green Basket using the following criteria:

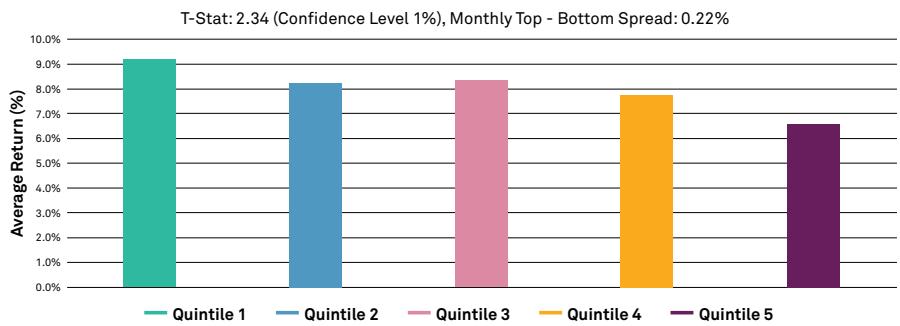
- Independent/Dependent Variable: Green Revenue Percentage/Forward Returns
- Green Revenue Percentage bucketed into 5 Quintiles (Highest Green Revenue Percentage in Quantile 1)
- Quantiles are Country & Sector Neutral
- End of Month Rebalancing
- 1 Month Forward Equally Weighted Quintile Return

Fig 2: Developed Markets (Mid & Large Cap) Green Revenue Quintile Cumulative Log Returns



Source: Trucost analysis. Current as at June 2020

Fig 3: Annualized Average Monthly Return by Quintile, Trucost “Green” Large & Mid Cap Mar 2010 – June 2020



Source: Trucost analysis. Current as at June 2020

Quintile Performance

Quintile 1 (which contains the companies that have the highest exposure to green revenue from the Green Basket) outperforms Quintile 5 on average by 22bps/month, or an average Top/Bottom Spread of 2.59% annually.

This back test suggests that within companies that have any exposure to green revenue (>1%), the companies that exhibited a higher percentage of green revenue outperformed those with the lowest exposure to green revenue.

Results

Interestingly in the first back test on Green versus Brown Portfolios, there is no sacrifice in the return profile. Based on this, in the 2nd back test one could expect that after drilling into the exposure of green revenue percentage in the Green basket that there would be minimal differences across quintiles, yet there is. There is a monotonic relationship between the quintile performances and quintile 1 outperforms quintile 5 at a 1% confidence level; this would warrant further investigation as to ascertain why.

As the momentum builds globally in environmental, social and governance policies, governments are starting are starting to design and implement the frameworks that will regulate these policies increasing the transparency of ESG risks and opportunities across capital markets.

The EU Taxonomy being one of these frameworks.

Companies in the EU will be mandated to report on their environmental impact. Trucost data can help support the reporting process, facilitate back testing and isolate companies that are best placed for the low carbon transition.

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