S&P Dow Jones Indices

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Do Physical and Transition Climate Risks Translate Into Investment Risks?

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As climate risk becomes better understood, interest in ESG investing grows. Jaspreet Duhra, Global Head of ESG Indices, and Muhammad Masood, Director of iShares Sustainable Investing, explore what's driving heightened adoption of ESG strategies, ways to assess companies' physical and transition climate risks, and the wide range of targeted ESG strategies now accessible to market participants looking to mitigate risks like these.

S&P DJI: ESG investing has become a more mainstream notion in recent years. What catalysts do you see driving that shift?

Muhammad: We are seeing a shift toward sustainable investing. To put this into context, EMEA investors are anticipating nearly 50% of their AUM to be in sustainable investing by 2025—this is up from just 21% in 2020.[1] We have already started to see this fundamental reallocation of capital; in 2020, there were net inflows of USD 425 billion into sustainable assets globally. In H1 2021, we have already seen USD 353 billion.[2]

This shift into sustainable investing has resulted from a range of factors, driven by changing consumer and investor preferences, improved sustainability data, and more sustainable investment options designed to meet various ESG and investment goals and the requirements of increasing regulation. This is fueling a global reallocation of capital toward more sustainable companies, which we expect to continue over many years.

[1] Source: BlackRock, "Sustainability Goes Mainstream, 2020 Global Investing Survey", EMEA results, December 2020, Survey of 425 clients representing USD 25 trillion in AUM.

[2] Source: BlackRock Global Business Intelligence, as of June 30, 2021.

S&P DJI: What role do you see for index-based strategies and ETFs in ESG investing?

Muhammad: Index investing has become a more common option for many investors looking to integrate sustainable considerations into their portfolio, and we see this through asset growth. AUM in index mutual funds and ETFs stands at over USD 630 billion as of June 2021, compared to just USD 469 billion at the end of 2020 and USD 220 billion at the end of 2019.[3]

Much of this demand comes down to the choice that exists in the indexing space. Sustainable index funds and ETFs are covering exposures across almost every corner of the equity and fixed income investment universe and investors can also choose the sustainable approach that works for them. They can pick a business-involvement-screened product, an ESG-tilted fund that maintains minimal tracking error with its underlying index, or a product that selects only the top ESG performers. Thematic and impact investing are also possible through ETFs, for example through clean energy and green bond ETFs. The rules-based approach adopted by index funds and ETFs can bring greater control and transparency to sustainable investing. Investors can learn the datasets being used, the criteria for security selection and weighting, and ultimately have full transparency into the ETF holdings, potentially giving them insight into why certain companies or issuers are being chosen and why others are excluded. As the regulatory landscape around sustainability evolves and investors look to adapt to this, index-based investing can play an instrumental role.

[3] Source: BlackRock Global Business Intelligence, as of June 30, 2021.

S&P DJI: S&P DJI publishes the S&P PACT™ Indices (S&P Paris-Aligned & Climate Transition Indices). How do the S&P PACT Indices specifically seek to align with the EU Paris Aligned Benchmark regulation and a net-zero-by-2050 scenario?

Jaspreet: The S&P PACT Indices include indices that are designed to meet the EU's minimum standards for both EU Climate Transition Benchmarks and EU Paris Aligned Benchmarks laid down in the EU Benchmark Regulation. A key requirement for these indices is for an initial 50% (Paris Aligned) or 30% (Climate Transition) reduction in relative GHG emissions from the parent index and a 7% year-on-year decarbonization trajectory, which, according to the EU Technical Expert Group on Sustainable Finance, is required to meet the Intergovernmental Panel on Climate Change's "1.5°C with no or limited overshoot" emissions scenario. In this scenario, greenhouse gas emissions would reach net zero by approximately 2050.

In our S&P PACT Indices, we have sought to achieve this decarbonization trajectory in two ways—first, by using current company carbon intensity data and shifting the weight toward companies with lower carbon intensities at each quarterly rebalance as required. Second, given the backward nature of carbon footprints, we also wanted to use a forward-looking dataset to identify which companies are on track to being aligned with a 1.5°C scenario over the coming years. To do this we used a new and innovative dataset from S&P Global Trucost called the Transition Pathway Approach.

S&P Global Trucost provides a forward-looking assessment first by using decarbonization paths recommended by the Science Based Targets initiative to determine companies' carbon budgets, or the amount of carbon that can be emitted while aligning with a 1.5°C scenario over the coming years. They then estimate what the actual emissions of companies may be over a future time period and determine whether companies are likely to be under or over their allocated budget. When we identify a company that falls under its allocated budget, we can potentially overweight that company in the index, helping the index to organically decarbonize.

S&P DJI: Taking a step back and looking at climate investing more broadly, in what ways do you see climate investing impacting investors around the world?

Muhammad: When it comes to the risks posed by climate change, these are generally split into two

categories—**physical risks** and **transition risks. Physical risks** directly impact a company's operations and are caused by the direct impact of changing weather patterns and natural catastrophes, such as rising sea levels, hurricanes, flooding, drought, heat, and wildfires. More than half of the world's total GDP has a direct or indirect dependency on nature—all asset classes around the world could be impacted by the physical effects of climate change.[4] **Transition risks** arise from the efforts to deal with climate change, including technological innovation, evolving consumer and investor preference, and regulatory impact.

[4] World Economic Forum, "Nature Risk Rising: Why the Crisis Engulfing Nature Matters for Business and the Economy," January 2020.

All these factors can financially impact portfolios. To take each in turn:

- **Regulation:** 127 governments around the world are either considering or already implementing commitments to carbon-neutral economies. Regulations such as the European Union's Sustainable Finance Disclosure Regulation (SFDR) are already having a significant impact on how investors plan to allocate capital going forward and how fund providers build funds.[5]
- **Innovation:** Emerging technologies and innovation are helping to deliver cheaper renewable energy sources and enabling new advances, which will in turn enable scaled production and widespread adoption.
- **Preferences:** In parallel with growing recognition of the climate threat, consumers and investors increasingly demand that companies and brands do their part to minimize their environmental impact—and companies are moving quickly to demonstrate their commitments.

We believe with this increased impact of climate on asset prices comes both risk and opportunity for investors.

S&P DJI: Why was it important to capture physical ESG risk data in the S&P PACT Indices?

Jaspreet: The physical risks of climate change are unfortunately very evident today, on our doorsteps and in images we see in the media. As warming continues, these impacts may become even more pronounced. We felt it was important to incorporate both transition and physical risks in the S&P PACT Indices as the two risks are not connected. Companies that are well-positioned to transition to 1.5°C may still have high physical risk exposure.

Physical risks can be both chronic and acute in nature. Acute risks are extreme weather events such as hurricanes and floods, whereas chronic risks are long-term weather pattern changes such as rising global temperatures and rising sea levels. Both chronic and acute physical risks can financially impact companies,

[5] BlackRock, Larry Fink's 2021 Letter to CEOs, Jan. 26, 2021

for instance by forcing the closure of factories and offices, creating problems in supply chains, increasing insurance premiums, and the list goes on.

The physical risk assessment of companies is based on a forward-looking dataset. Over 2.8 million physical assets, including offices and factories, have been assessed against seven different types of physical risks including hurricanes and heatwaves.[6] In the S&P PACT Indices, we dynamically cap the weight of individual companies based on their exposure to physical risks, and we ensure the indices have a lower overall exposure to physical risks.

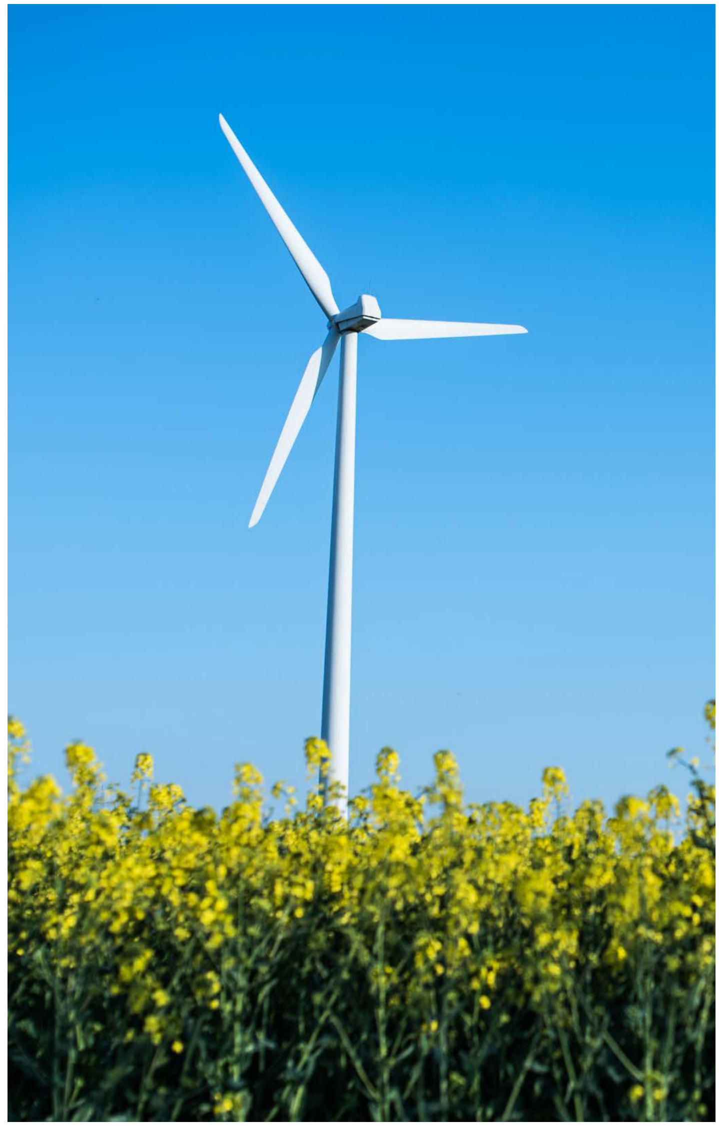
We don't know what the future holds when it comes to our climate. We want to make sure our index is aligned with a 1.5°C scenario, but if society does not manage to limit warming, investors may want to avoid the increased physical risks of climate change.

S&P DJI: How can investors incorporate climate risks and opportunities into their strategies?

Muhammad: While an increasing number of investors are accepting that climate change brings certain investment risks and opportunities, the ways they choose to implement their view can vary. Some prefer to focus on reducing exposure to fossil fuels or to tilt away from high-carbon-emitting companies. Others are incorporating forward-looking metrics such as physical risk indicators or taking into account corporate emission reduction targets. A more targeted approach adopted by some includes focusing on certain sustainable thematic strategies or impact investing. At BlackRock, we offer products across all three approaches so investors can choose for themselves the best way to incorporate climate into their portfolio.

S&P DJI: How do you see climate investing evolving over the next 10 years?

Muhammad: We have seen increasing focus on climate change from consumers, regulators, and investors. This in turn has been shifting corporate behavior. Companies are starting to build sustainable business models, disclose on their policies, and report their emissions. We believe this trend will continue to accelerate, with investors responding to increasing pressure to have more and better-quality data pertaining to environmental factors. This will be integral to constructing more targeted strategies focusing not



only on mitigating climate change but also on adapting to the various adverse impacts of climate change.

Climate integration in portfolios may also move beyond just security selection at a product level to a more holistic approach where strategic asset allocation decisions also incorporate the risks and opportunities of climate change. In the construction of targeted thematic strategies and implementing strategic asset allocation decisions, indexing will continue to play a key role in the climate investing space.

While implementation approaches may vary from investor to investor, at BlackRock, we believe climate risk is investment risk and therefore the acceleration toward climate investing is just getting started.

[6] S&P Global Trucost, July 2020

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