Assessing Carbon Resilience of Australian Equity Managers

By

Jay Kumar

Foresight Analytics
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www.foresight-analytics.com

Key Insights

- As governments and investors set targets to achive a net-zero emissions in the future, investment managers, capital allocators and consultants have a fundamental role to play in the transition process.
- While advancements in data, analytics and reporting enhance the transparency around carbon risks, performance, transitions and scenario analysis, active managers have key role to play in assessing true risks and possible transition scenarios that occur at the company level. The complexity of this task means there will be long term losers and winners. This type of pay-off offers active investors an opportunity to not only manage envionmentals risks in a proactive manner but also use it as a source of alpha generation.
- Carbon benchmarking of Australian share managers by Foresight shows significant level of dispersion in relative carbon emissions and carbon intensity per million dollar of revenue. It is worth noting that a lot of the benchmark relative dispersion is driven by sector allocation as opposed to security selection decision.
- The good news is that many active Australian share strategies offer a carbon efficient portfolios related to the benchmark. These carbon light or carbon resilient portfolios are offered by managers that are actively seeking to reduce carbon in their portfolio as well as those who simply choose to avoid carbon intensive companies as part of their quality focus. A low carbon portfolios aim to manage climate risk by meaningfully reducing the carbon exposure.

Aligning towards net-zero economy

As investors are increasingly seeking alignment with a net-zero economy, measuring and managing climate risk has become an ever-more important ingredient of the institutional investment process. So is identifying new and innovative low-carbon investment opportunities in order to help build more climate-resilient portfolios.

Governments and investors are increasingly setting targets to achieve net zero emissions by no later than 2050, but current action plans fall well short of meeting the 1.5/2c degree pathway set forth by the Paris Agreement. The investment sector has a fundamental role to play in mitigating a climate crisis and setting the global economy on track for a cleaner, sustainable future.

Low carbon strategies

Many active manager portfolios we have analysed have carbon efficient portfolio relative to the market benchmark such as S&P/ASX200 Index. Some of these managers target low carbon risk companies while others avoid high carbon intensive industries such as Materials and Energy. In conducting manager diligence, it is important to understand both the absolute level (tCo2e) and relative levels of carbons risks in portfolios. In addition, it is also instructive to isolate whether the carbon advantage is a driven by allocation to sectors or stock picking decisions. This type of attribution is similar to the Brinson performance attribution using holding data of portfolio managers.

Carbon footprint and footpath

While assessment of carbon foot print provides a good level of insights into carbon risks, carbon drivers and outcomes, active manager may also consider the carbon footpath. Such as the focus could be not just on current and historic carbon risks but also how the company adopts to new carbon economy in the future; what threats exists to current assets; and what type of financial risks may be imposed due to transitioning stranded assets. Further, managers also need to consider emissions not just from the direct company activities but also from indirect causes of emisions. Foresight uses data that captures Scope 1, 2 and 3 which means both direct and indirect effects are captured. Today, data is available to scenario test a companies future carbon emissions based on a range of variables. This type of approach incorporates not just Scopes 1-3 but also Scope E (estimates). While any modelling of climate risk and carbon assessment is not a precise science, active investors can at least consider a range of scenarios under which stranded assets should be written off or how to price the risk for companies and assets that are transitioning to new economy. We believe this is where the carbon-transition alpha opportunities exists as investors re-price companies and assets for this 'transition' risk. Many backward looking analysis and simple analysis will not capture it effectively.

Key metrics used for carbon foot printing

One of the key questions that investors have to address is the level of portfolio's exposure to carbon intensive companies.

Foresight measures carbon emissions (CE) and carbon intensity (CI) associated with companies in a fund, ETF or index, drawing on carbon expertise and research of Foresight and data provided by Refinitiv, Truecost and Sustainalytics.

Since companies with higher carbon emissions and intensity are likely to face more exposure to carbon related market and regulatory risks, this metric indicates a portfolio's exposure to potential climate change-related risks relative to other portfolios or a benchmark.

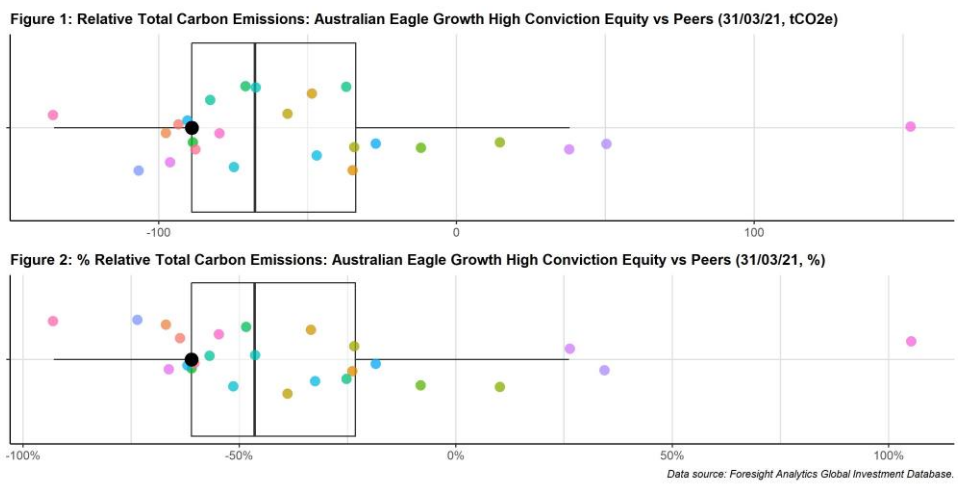
The analysis presented in the paper draws upon carbon emission data from Refinitiv. Foresight calculates the level of financed carbon emissions in tons for each company and it is rolled up to provide the overall exposure of the portfolio. The level of emission in tons can be compared to a benchmark (S&P/ASX 200 index) or relative to other managers in a peer group. Foresight also calculates the carbon emissions intensity ratio (tons of carbon per dollar of revenue) for each company and it is rolled up to provide the overall exposure of the portfolio. The level of emission intensity ratio can be compared to a benchmark (S&P/ASX 200 index) or relative to other managers in a peer group.

Carbon Emission (CE) of Australian equity funds - overall

Exhibit 1 & 2 present the carbon emission level of Australian share managers included in the Foresight study assuming AUM of 1 million dollars. The data is presented relative to the index – S&P/ASX200 Index and we make the following observations.

- there is a high dispersion in level of carbon emitted by portfolio, ranging from -96% to +100% relative to the index.
- total carbon emission of the highlighted fund Australian Eagle Growth High Conviction Equity (AEGF) is -89 tCO2e relative to the index (146 tCO2e less 57 tCO2e). In percent terms, AEGF low carbon advantage is -61% relative to the index (Figure 2).
- In both cases, AEGF's relative carbon advantage is better than the median manager.
- The median manager in the Foresight study has a relative carbon advantage of -48% relative to the S&P/ASX200 index.

Exhibit 1 & 2: Relative Carbon footprint of Australian share managers



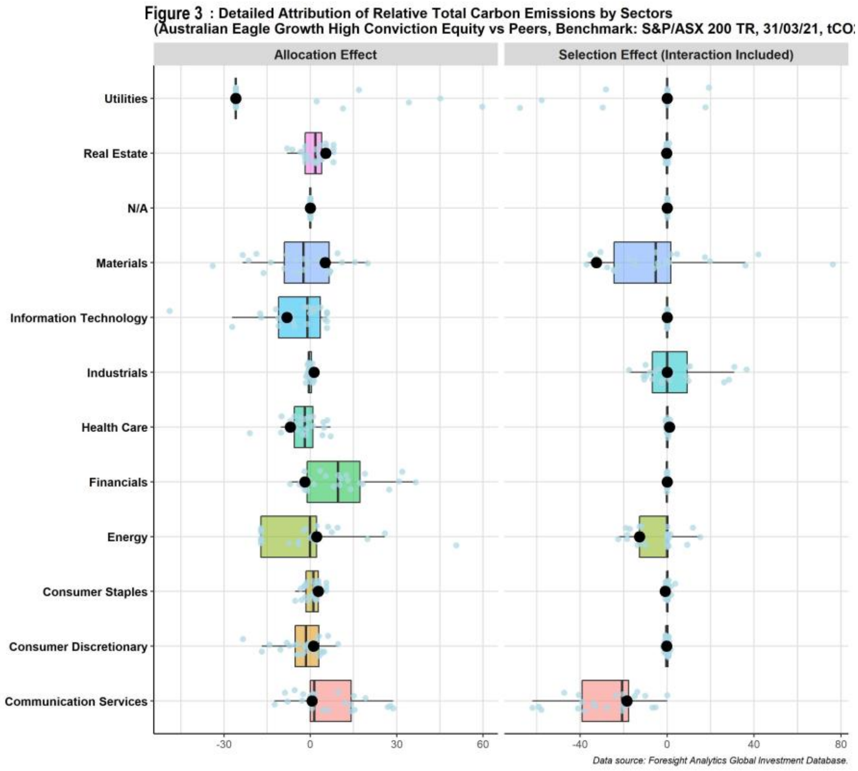
Carbon Emission (CE) of Australian equity funds - Sectors

The two principal reasons why the carbon exposure of the portfolio may differ from the benchmark are due to sector/market allocation as well as stock selection within sectors/markets decisions. Attribution Analysis explains how sector allocation and stock selection contribute to a smaller or larger footprint relative to a benchmark. This can be used to identify opportunities for future footprint reduction. If the portfolio is overweight in carbon intensive sectors/markets, the portfolio is likely to be more carbon intensive than the benchmark. However, if the stocks within a carbon intensive sector are the most carbon efficient companies, it is possible that the portfolio may still have a lower carbon footprint than the benchmark. Interaction effect is included in stock selection effect.

Exhibit 3 presents the carbon emission level of Australian share managers by sectors and by decision type – allocation versus selection. The data is presented relative to the index – S&P/ASX200 Index. Our observations are as follows.

- there is a high dispersion in sector allocation effect with Materials, Financials, Energy and Communication services being the outliers.
- Within the selection decisions, dispersion is more limited and concentrated in Materials, Energy and Communication services.
- The median manager in the Foresight study is able to use good selection decision to eek out a relative carbon advantage in mainly Materials and Communication Services sectors.

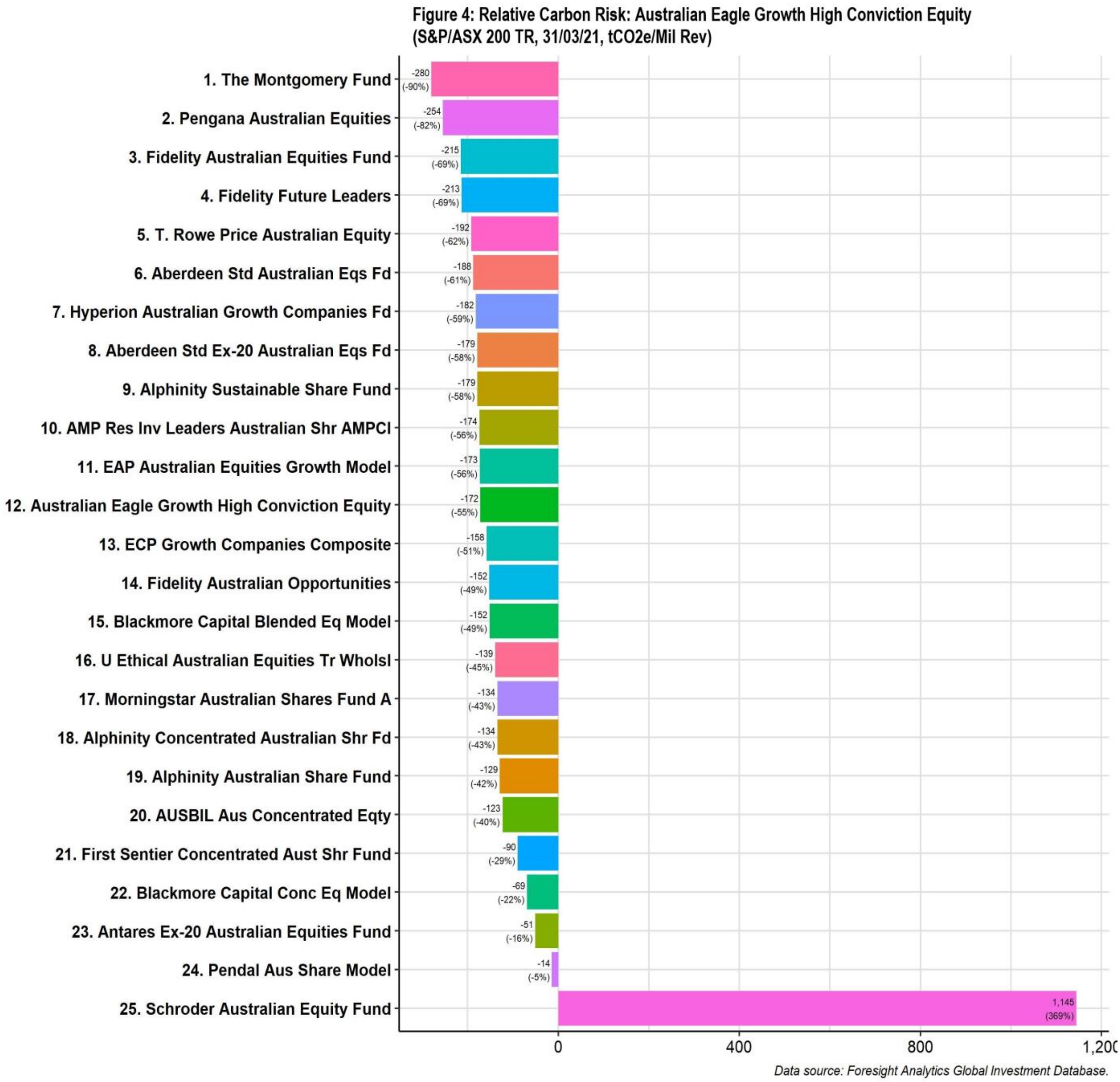
Exhibit 3: Relative Carbon footprint of Australian share managers



Carbon Intensity Ratio (CIR) of Australian equity funds - overall

A portfolio's relative weighted average carbon intensity (Relative carbon risk) measures its difference in the weighted average carbon intensity compared with that of a benchmark in tons per million AUD of revenue. A portfolio's relative weighted average carbon intensity ratio expresses the difference in percentage term. Exhibit 4 presents the relative carbon intensity of active managers in the study sample. The data shows that the relative Carbon intensity measure of managers ranges from -200 tCO2e to +1145 tCO2e per million dollar revenue. In relative percentage terms, the data ranged from -90% to +369%. This level of dispersion means investors have significant opportunity to select managers that are not only skilled at delivereing positive financial outcomes but can delilver more carbon resilient portfolios.

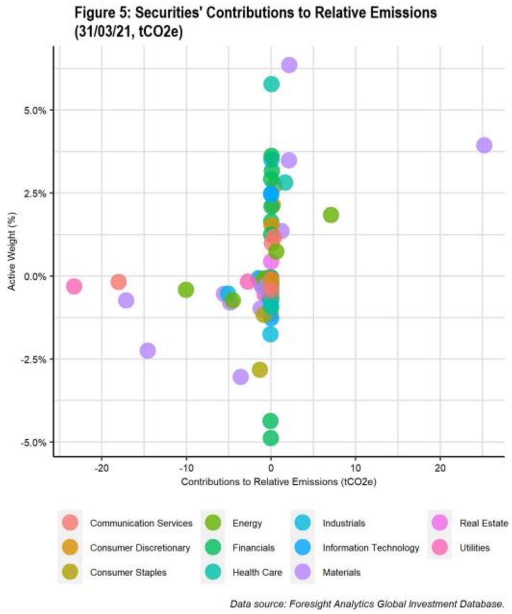
Exhibit 4: Relative Carbon Intensity of Australian share managers - overall



Key drivers of emissions - security

Drilling down to stock position of a manager from both active risk perspective and carbon conributon perspective can quickly show the interaction between carbon and conviction. Figure 5 shows the distribution of AEGF'sactive positions and their carbon contributions. The data is presented relative to the index and shows that majority of AEGF's positions are neutral carbon contributors. There are a few outliers which generally orginate from Energy and Materials sector for example.

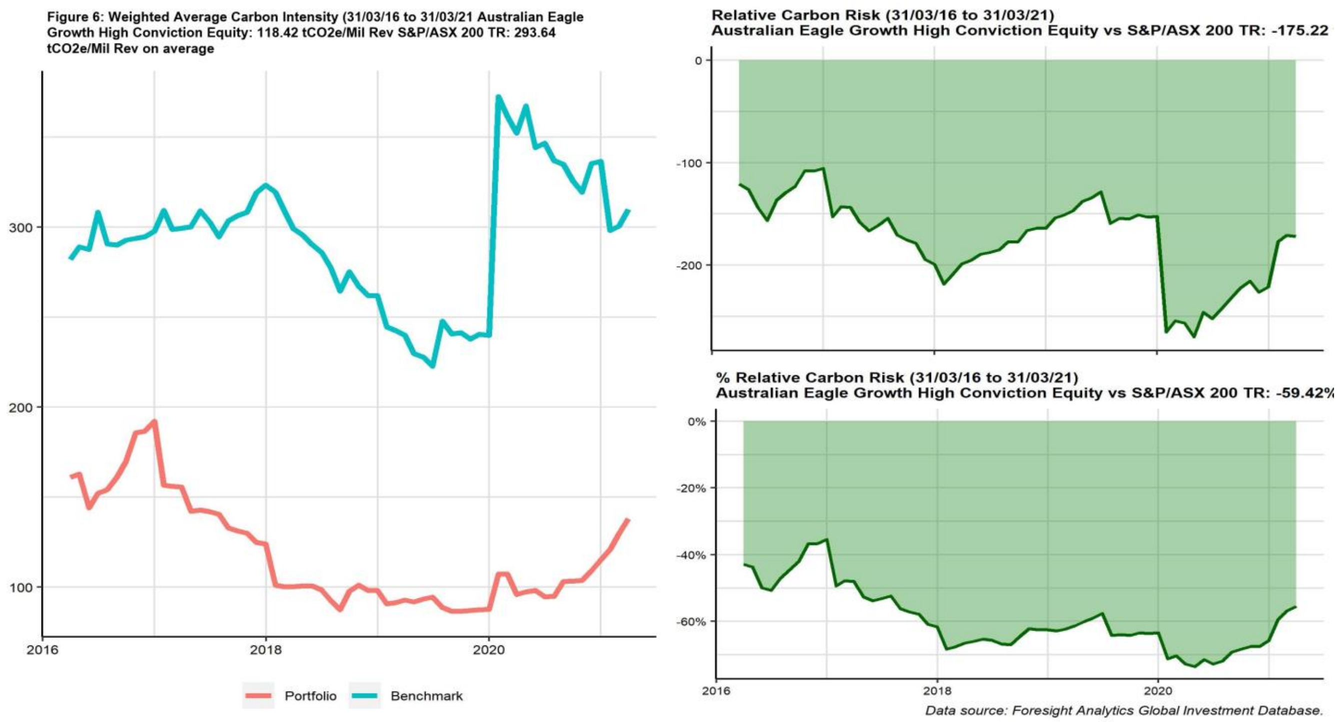
Exhibit 5: Interaction between Active weight and Carbon contribution in a portfolio



What about cyclical versus structural carbon advantage?

To understand the intrinsic carbon biases of manager portfolios in any due diligence work, one needs to understand the nuanced aspects of their process, conduct analysis of carbon risks both at a point in time as well as over time. This type of approach can assist investors help investors to determine if low carbon position of a manager is driven by luck (one-off or transient) or by process and skill (persistent and structural). This type of analysis can be done for a manager in the context of its own history as well as relative to the peer group. We present the historical trend analysis of AEGF relative to the index. The data demonstrates strong and persistent carbon advantage of AEGF. Investors in AEGF can rely on the management team to consistently built carbon resilient portfolios.

Exhibit 6: Interaction between Active weight and Carbon contribution in a portfolio



Concluding comments

While advancements in data, analytics and reporting enhance the transparency around carbon risks, performance, transitions and scenario analysis, active managers have an important role to play in assessing true risks and possible transition scenarios that occur at the company level. The complexity of this task means there will be long term losers and winners. This type of pay-off offers active investors an opportuni-ty to not only manage envionmentals risks in a proactive manner but also use it as a source of alpha generation.

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