

A landscape overview of transition-oriented climate indexes



Over the past couple of years we have been working with asset owners of all types to help them assess and select an equity index that reflects their climate ambitions.

With the myriad of transition-oriented climate indexes increasingly being launched, asset owners are looking to understand the landscape of these products and whether these align to asset owner beliefs. This article provides an overview of some of our observations on:

- The evolution of third generation (3G) indexes¹
- The characteristics of transition-oriented climate indexes, and
- Asset owner considerations in determining their approach to transition-oriented climate index selection.

¹ Please see Mercer's 2020 paper [Moving to 3G – The third generation of climate indexes](#) for further details on the different generations of climate indexes.



Background

Client interest in transition-oriented climate indexes has increased, and as a result, so have the offerings from index providers.

3G indexes are positioned not only to penalise laggards (companies with high carbon emissions and climate-transition risk), but also reward companies producing green revenues, as well as companies that are “in between” (those that have the capacity to demonstrate the potential to transition to a low carbon economy).

In our view, engagement to encourage companies to disclose climate data and align their business strategies to a [net-zero economy](#) is a critical component of transition-oriented climate indexes. This is also a key differentiator amongst some indexes, where we see outcomes of shareholder engagements better reflected in the index methodology, and therefore index weights, of some indexes relative to others. However, most index providers do not conduct any engagement themselves; rather this tends to be a function of the asset manager tracking the index or undertaken by the asset owner. Although many index providers indicate that these transition-oriented climate indexes may reflect outcomes of engagement, this tends to be obscured by complex index construction approaches. It is therefore crucial for asset owners to be aware of such issues when selecting a transition-oriented climate index, and when selecting a manager who will implement the index.

Index providers have been active in developing and launching transition-oriented climate indexes, however implementation by asset managers tracking these indexes has been slower. Instead, we have seen some asset managers focus on an enhanced index approach, creating bespoke climate or environment-related variations of market-cap indexes as a low-cost solution. As investor demand for transition-oriented climate indexes increases, along with investor commitments, such as net-zero initiatives, we expect more asset managers to implement both: off-the-shelf transition-oriented climate indexes; or low-cost enhanced indexation or systematic solutions that follow similar characteristics and objectives. We have already seen managers incorporate innovative elements into solutions in order to remain competitive and we expect this to continue.



Evolving attributes of 3G climate indexes

The landscape for 3G indexes has evolved: we have seen the complexity of these indexes increasing as they aim to be more forward-looking. The key attributes of 3G indexes include:

Temperature alignment: many index providers have created proprietary or adopted third-party provided temperature scenario analysis into their methodology and adjust constituent weights towards those more aligned to a 1.5 degree scenario. The approach and underlying assumptions used for temperature alignment analysis varies by each provider.

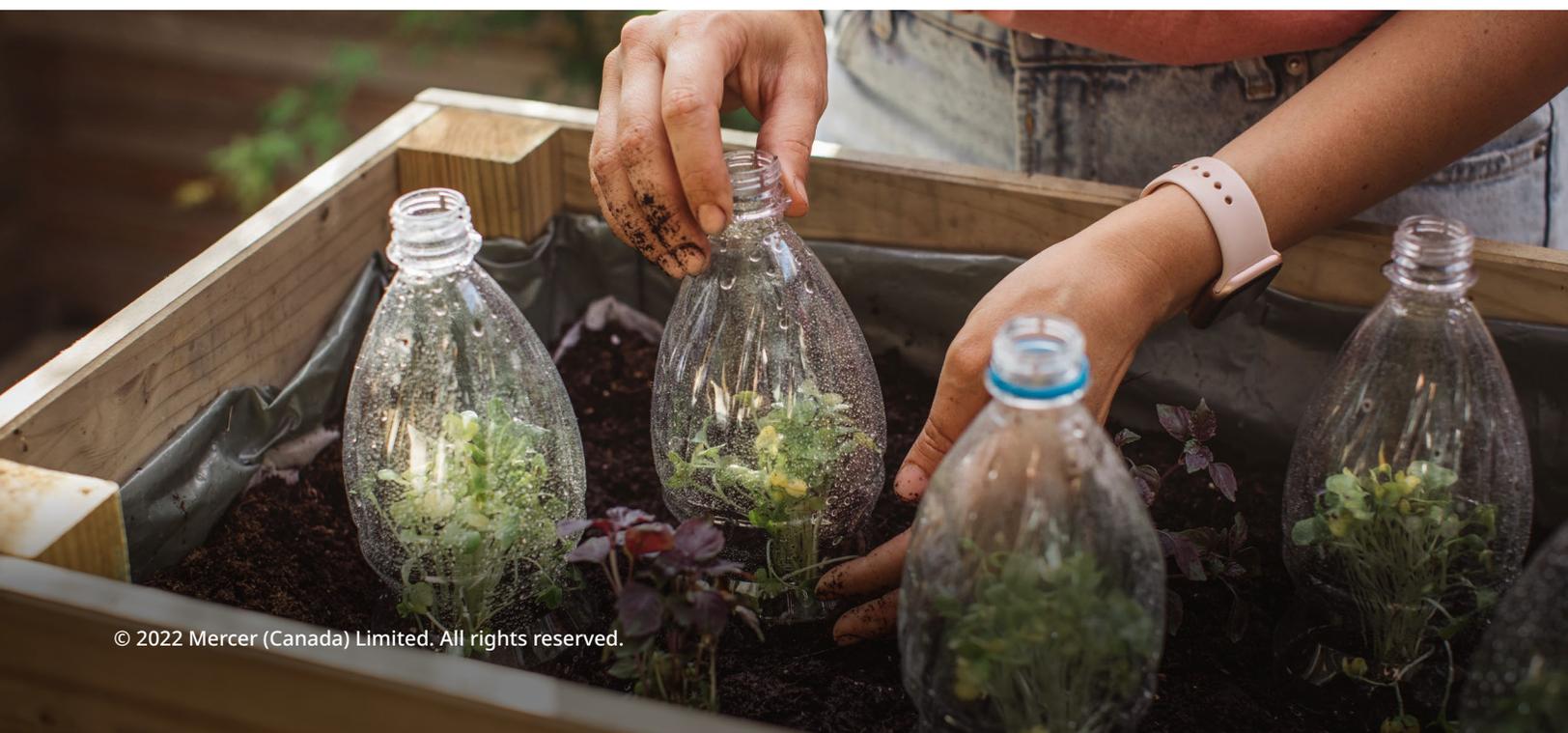
Science-based targets (SBTs) are an example of an industry-wide accepted approach for companies to commit to carbon-reduction targets that are independently validated by the Science Based Targets initiative (SBTi). This is another way index providers are adopting forward-looking commitments into the methodology of index construction. Index providers typically do this by placing a greater (index) weight on companies that have these climate-transition commitments embedded into their business strategy.

Stewardship of climate-transition objectives and carbon disclosure is key to influence companies to transition towards a low carbon economy and meet temperature alignment goals. The index methodology may provide a clear approach to engagement.

Scope 3 carbon emissions² are already phased in by some index providers using various estimation approaches.

Green revenues tend to reflect the focus of companies on climate solutions. As the opportunity set for green solutions increases, we would expect to see the potential for greater allocation to these companies. Currently, this is reflected in transition-oriented climate indexes, although index providers can increase/decrease the proportion to green revenues based on client requirements.

² The Greenhouse Gas Protocol Corporate Standard classifies a company's greenhouse gas emissions into three scopes. Scope 1 emissions are direct emissions from owned or controlled sources. Scope 2 emissions are indirect emissions from the generation of purchased energy. Scope 3 emissions are all indirect emissions (not included in scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions



European Union climate benchmark regulations

The European Union (EU) Climate Benchmark Regulations provide specific criteria that index administrators must have in place in order to label an index as either a EU Climate-Transition Benchmark (EU CTB) or a EU Paris-Aligned Benchmark (EU PAB).³ There are a number of considerations of aligning indexes to the EU regulations, including:

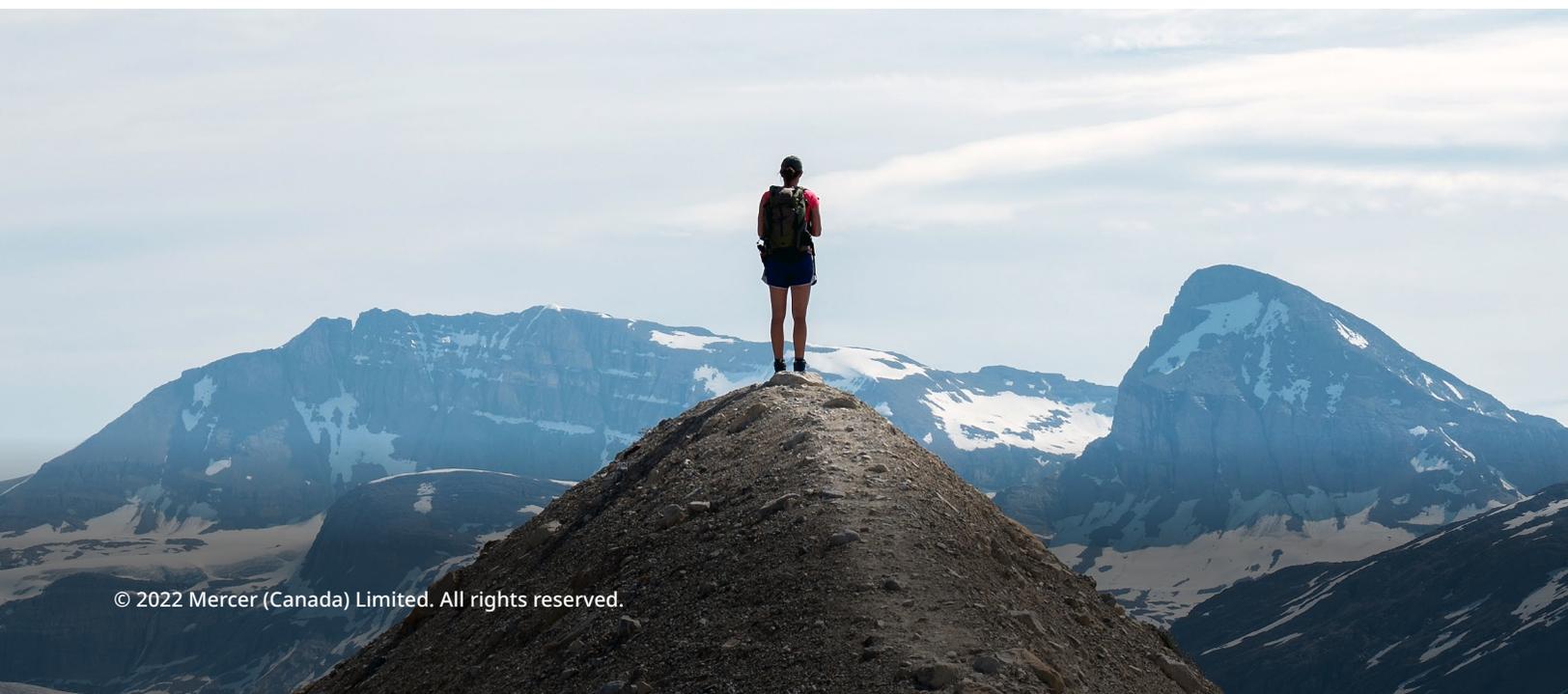
Real world impact vs exclusions: this is a key question that investors have asked when focusing on climate transition as well as Paris-aligned indexes – what are we trying to achieve? Portfolio carbon reductions, or carbon reduction in the economy? According to the IIGCC Paris Aligned Investor Initiative “the opportunity to maximise real world impact in the economy” may be more effectively achieved through “maintaining investments in assets by driving reductions in companies that need to transition through stewardship and engagement, rather than initially excluding issuers from a benchmark to achieve an immediate ambitious emissions reduction target”.⁴ Investors should be aware of what they are excluding on the basis of the minimum criteria for EU indexes.

Definitions of high/low impact sectors: The EU requirements have provided a definition on what are considered high and low climate impact sectors. For example, according to the EU definitions, banks/financials are considered a low climate impact sector. However, given that banks are providers of fossil fuel finance, we question whether this sector should instead be considered a high climate impact sector. Some index providers are indeed taking various approaches to capture banks/financials as a high climate impact sector in their index methodology.

Alignment with asset owner beliefs: The EU indexes are a good starting point for asset owners wanting to align investments with the climate objectives. However, investors may stray from the EU labels if some of these standards do not meet their own beliefs – for instance they may wish to create a customised climate-transition index with their index provider.

³ Please see Mercer’s 2020 paper [Moving to 3G – The third generation of climate indexes](#) for further details on the framework for EU CTB and EU PAB

⁴ [Net Zero Investment Framework Implementation Guide, IIGCC](#)



Reviewing climate transition indexes

The world of transition-oriented climate indexes has evolved rapidly. Given these are not simple passive market cap strategies, the approach we have taken to due diligence is similar to that for active strategies. This is because rules-based indexes require a number of active decisions including the data inputs, assumptions, and active weights vs the market cap benchmark.

In our discussions with investors considering transition-oriented climate indexes, some of the key questions they asked included:

- What are the differences in the inputs and assumptions that index providers have to construct their index?
- How do the style/regional/industry biases differ across indexes?
- What impact do the inputs and assumptions have on risk/return, style and climate characteristics?

We have undertaken due diligence on a number of transition-oriented climate indexes over 2021⁵, broadly using our four-factor framework. The index approaches vary significantly, and the assumptions that index providers make on a number of inputs (such as their approach to scope 1,2,3 emissions, their approach to forward-looking climate metrics i.e. temperature alignment, scenario analysis) can lead to indexes that look different, and significantly so in some cases.

Inevitably, transition-oriented climate indexes vary in characteristics across risk/return (based on back-tested data), style, ESG, region, sector, and climate metrics. We have a number of specific observations on these indexes:

- **Carbon:** All transition-oriented climate indexes (especially those following the EU recommendations) have significantly lower carbon emissions than the market cap benchmark, and positive tilts towards environmental factors.⁶

- **Risk/return:** Actual returns and tracking error (relative to their respective market capitalization equivalent) are dependent on the constraints for index construction around the market cap constituent weights (for instance for region and sector variations). Indexes following strict characteristic limits to that of their respective market cap benchmark have exhibited lower historic excess returns and lower associated tracking errors. There is relatively high active share compared with the broad benchmark across all indexes.
- **Style and region:** By style there are mixed growth and value tilts across all indexes, although quality tilts tend to be relatively consistent for all indexes. Regional tilts are broadly neutral. The marginal under and overweight allocations by region are seen mostly in Europe and the US, however without a clear pattern across all indexes.
- **Industry:** A key difference across index providers is their treatment of sector deviations versus the market cap benchmark. The EU guidelines state that exposure to the set of high climate impact sectors must be equal or greater than that of the exposure in the underlying universe to the same set of sectors. This is to try to combat simple decarbonization approaches that typically lead to underweighting high carbon emitting sectors where many solutions necessary to a low-carbon economy lie. “High climate impact sectors” are classified by the EU under the defined NACE⁷ sector classifications. This guidance leads to greater expected sector deviations versus the market cap benchmark. However it should be noted that index providers typically use their own industry classification (such as GICS or global industry classification sectors) in their index construction (rather than the NACE classifications).

Most index providers have a significant underweight to the energy sector relative to their respective market capitalization benchmarks. We note that the utilities sector has one of the lowest absolute exposures across all indexes yet it contributes the most, in general, to carbon intensity (even when the transition-oriented climate indexes are underweight to utilities compared with their market capitalization benchmark).⁸

⁵ Indexes reviewed: FTSE Developed CTB index, S&P Developed Ex-Korea LargeMidCap Net Zero 2050 Climate Transition ESG Index, MSCI World Climate Change Index, SciBeta Developed Climate Impact Consistent (CIC) Index

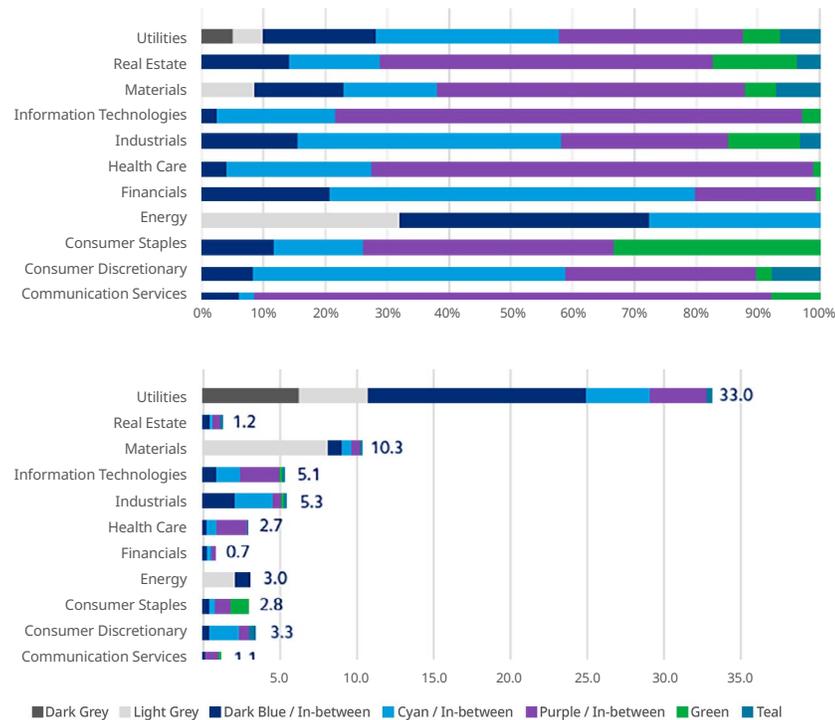
⁶ Environmental factors are analysed using MSCI ESG scores in Style Analytics

⁷ Nomenclature of Economic Activities (NACE) is the European statistical classification of economic activities.

⁸ Source: Mercer Analytics for Climate Transition analysis based on indexes analysed during 2021.

- Climate:** Using Mercer's Analytics for Climate Transition (ACT)⁹ tool, each of the indexes temperature alignment can be determined. All indexes analysed fall into an implied temperature rise of 2.0-2.3° Celsius. We note that this is above a 1.5-2.0° Celsius scenario, which is consistent with the Paris Agreement, adopted at COP21 in 2015. Indexes have the majority of their exposure to "in-between" assets¹⁰ which is what we would expect for a transition-oriented climate index. Carbon intensity levels are driven by indexes exposure to "grey risks".¹¹ Within grey assets, the majority is typically driven by exposure to stocks in the utilities sector, followed by stocks in the materials and energy sectors. An example ACT analysis for one of the transition-oriented climate indexes we have assessed is shown in Figure 1.

Figure 1. Example ACT analysis for a transition-oriented climate index



Source: Mercer - For illustrative and discussion purposes only.

All indexes have some exposure to green revenues but to varying degrees. The exposure to green revenues varies across sectors and would typically depend on how an index provider defines green revenues.

⁹ For more information on ACT: <https://www.mercer.com/our-thinking/wealth/zero-places-to-hide.html>

¹⁰ "In-between assets" are those companies with varying carbon intensity and transitions prospects. We have divided these in-between assets into three different sub-categories.

¹¹ Grey companies are those that have high carbon intensity and low transition prospects (divided into dark and light grey categories).



Asset owner considerations

The type of transition-oriented climate index that is selected by asset owners depends on where they are on their climate transition journey.

Asset owners have different aims when it comes to their decarbonization commitments and net-zero targets. Some are looking to switch out of existing low carbon indexes (i.e. first generation) to incorporate ones with more forward-looking transitional elements ([third generation](#)); others may look for a transition-oriented climate index as a secondary reference benchmark.

Asset owners typically want to use these indexes because they can help to capture [climate risk management](#), understand the transition capacity of companies in their portfolios, increase their exposure to climate solutions via green revenues, and promote stewardship with companies to transition to a low-carbon economy.

Asset owners' considerations and underlying beliefs determine which index is selected, such that interests are aligned. One of the main objectives of the EU CTB and EU PAB indexes is to allow a significant level of comparability in their objectives and methodologies.

Index providers can choose to follow the EU objectives strictly or exercise some flexibility when defining their final methodology. With this level of flexibility in mind, some questions for further alignment with asset owner interests are:

- Is the index future proofed for ongoing developments and is there scope to evolve in response to industry developments?
- Does the index incorporate [broader ESG criteria](#) (that is beyond just climate criteria)?
- How transparent is the methodology, given the rapidly evolving area?
- Can asset owners partner or influence the index provider to shape their core offering and accommodate customizations?

This is an important and ever evolving landscape and we will continue to keep abreast of major developments. We will be delighted to help support asset owners who need advice on selecting appropriate transition-oriented climate indexes. [Speak with a Mercer consultant](#) to get started.



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