

# The Art and Science of Climate Focused ESG Investing

By Dr. Pooja Khosla and Seann Stoner

This is Part 3 of a series of articles to review the ongoing market reaction to Covid-19 and the oil price wars. We explore in real-time the data and opportunities that can help reshape the recovery for a better climate future.

Numerous comparisons have been drawn between the impacts of the Covid-19 pandemic and the not-too-distant future consequences of climate change. Many actors within the financial services space, [including Entelligent](#), view the market response to the pandemic as a stress test similar to what the [Bank of International Settlements \(BIS\)](#) dubbed a *green swan event*. With [oil prices entering the negatives on April 20<sup>th</sup>](#), the double black swan event of dropping demand due to the pandemic and a large increase in supply from Saudi Arabia and Russia have many making the case that direct parallels can be drawn between this and the view that at some point in the future large amounts of oil and gas assets will become [stranded](#). With all this going on, impact minded investors have kept their eyes on ESG funds and funds that use [divestment](#).

As the [Financial Times](#) and [Morningstar](#) have recently pointed out, ESG funds have largely done comparatively well against the market. But if recent events are a stress test for what would happen to portfolios in the event of oil and gas markets failing due to global action on climate change, what can we learn about strategies that are marketed as being divested from the oil and gas sector?

Exchange Traded Funds (ETFs) such as [iShares MSCI ACWI Low Carbon Target ETF \(CRBN\)](#) with net assets at \$408.54M and [SPDR® MSCI ACWI Low Carbon Target ETF \(LOWC\)](#) with net assets at \$58.14 M are two leading funds that are based on minimal exposures towards carbon and fossil fuels. With these low exposures towards fossil fuel it is expected that these funds should show superior performance relative to the universe of MSCI ACWI constituents during the past quarter disruptions that shook the fossil fuel industry to a near death experience. However, while comparing the financial metrics for the past quarter, it is clear that the financial performance for these funds were essentially no different than their benchmark containing the oil and gas sector.



Table-1 Compares YTD returns for LOWC, CRBN, and ACWI. Source: Yahoo Finance

With this being the case, and assuming that it is still true that recent events are indeed a stress test for a future to come, how could the market change its approach and go beyond nibbling at the margins by investing in IT or green tech and towards a solution that could cause seismic changes to the underlying nature of our economy that has been built on the back of the fossil fuel industry?

For help answering this question, we look to the past. In 1603 a group of Italian scholars formed the Accademia dei Lincei (Academy of the Lynx-eyed) dedicated to the development of scientific thought and to fight against superstition. Galileo Galilei was one of its founding members and its symbol was that of a lynx. The story goes that the lynx was chosen by Academy members because of the Greek myth that these wild cats could see through solid objects. A lasting impact of this Academy was Galileo perfecting the first compound microscope and its naming by another of its members, Giovanni Faber. Among the many other well-known scientific accomplishments by *the father of the scientific method*, we can certainly thank Galileo for his contribution to the study of organisms invisible to the naked eye in addition to his work with the telescope and the world-changing proposition that the Earth does indeed circle the Sun.

The lesson here for climate focused impact investors is that to have a meaningful impact in aligning one's investment portfolio with the realities of climate science, one needs to be able to see as if looking through a telescope **and** through a microscope. Practically, this means using both traditional bottoms up analysis as well as a top down approach. Both of which need to use state of the art scientific methods.

The results from the Table-1 clearly indicate that for climate risk management, minimizing exposures towards emissions and fossil fuels is not sufficient as it uses the microscopic view of solely reducing emissions associated with a portfolio.

We need solutions that are much more robust to mitigate risks in the energy mix and transformations that are more desired and likely as a new normal for global economic growth post COVID-19. Leading data companies and fund managers are looking for solutions that factor in transition risk in addition to physical risk, to a low carbon future. Maybe it's time, in fact, to focus on maximizing relative carbon reductions rather than being limited to minimizing absolute carbon exposures, as we have argued [previously](#).

Clearly this crisis has us thinking philosophically, but what can be known for sure is that the recovery from the COVID-19 crisis will lead to a different economy. The question is, what will it look like? Normal may no longer be desirable by our leading financial institutions nor secure for their fossil fuel industry. It makes no sense to revive a dying oil industry only to kill it again a few years later to tackle the sustainability of our economy. It makes no sense to recreate jobs that will not survive the energy transition to what nearly all expect will eventually be a low carbon future. Fossil fuels are in decline despite already enjoying billions in direct and indirect government subsidies. [It appears that there is no scenario without severe cartel intervention where fossil fuels make a full and sustained recovery from this crisis.](#)

Already old and powerful institutions groan under our current situation, and only a few months into what [could be more than 18 months](#). So far, the situation is unfolding and revealing the stress of the underlying system.

[J.P. Morgan Asset Management on Tuesday \(April 14, 2020\) reported \\$2.239 trillion in assets under management as of March 31, down 5.3% from three months earlier and 6.8% higher than a year earlier.](#)

BlackRock shared its first-quarter report two days later (April 16<sup>th</sup>, 2020) showing assets under management totaling \$6.47 trillion in the quarter ended March 31, down 12.9% compared to the prior quarter.

[State Street Global Advisors had \\$2.689 trillion in assets under management, as of March 31, down 13.7% from three months earlier and 4.1% lower than a year earlier, parent State Street Corp.'s earnings release Friday showed.](#)

[Global growth is set to contract by 3% this year as the coronavirus pandemic and resulting lockdowns push developed and emerging economies into recession. Of more than 50 economists polled by Reuters, some forecast the world economy will shrink as much as 6% in 2020. The other extreme was a prediction for 0.7% growth. The average was a 1.2% contraction.](#)

The bigger question to address here is, do we have the data we need to develop robust strategies to address future shocks related to our health care systems, including the health and stability of our climate and towards a low carbon transition that sets us on path to a new normal? A new normal that might look like an investment pathway that has the capacity to minimize the volatility and return drawdowns that are in alignment with a recovery that maximizes value from the current COVID-19 scenario? Most current and popular market solutions are leaning towards strategies and indexes that reduce the absolute carbon footprint of an investment portfolio to mitigate climate change risk.

Entelligent's research team is working on methodologies that are focused on carbon reductions and impact additionality. Other firms such as MSCI, S&P, and Moody's are also leading the way.

Our reports are revealing how it is possible to evaluate holdings, reduce risk, and have impact by moving capital toward greater carbon reduction.

Our reports are under finalization and will be published broadly in the quarters ahead. Please stay tuned.