

Sovereign Note: The impact of Glasgow on Sovereign Investors

UBS Asset Management | **Global Sovereign Markets—views from our team**

COP26 meeting: Key decisions and announcements

World leaders met in Glasgow to discuss how to tackle the gap between the targets agreed at the 2015 Paris meeting and actions that nations have committed to. The challenge is that global greenhouse gas emissions in 2030 are expected to still be roughly twice as high as what is necessary to limit warming to 1.5°C. As a result, current 2030 targets would put the world on track for a 2.4°C temperature increase.

Expectations were high heading into Glasgow and given diverging interest across countries, a compromise was almost inevitable. This is exactly what the “**Glasgow Climate Path**” was and its main points are the following (the final text can be found [here](#)):

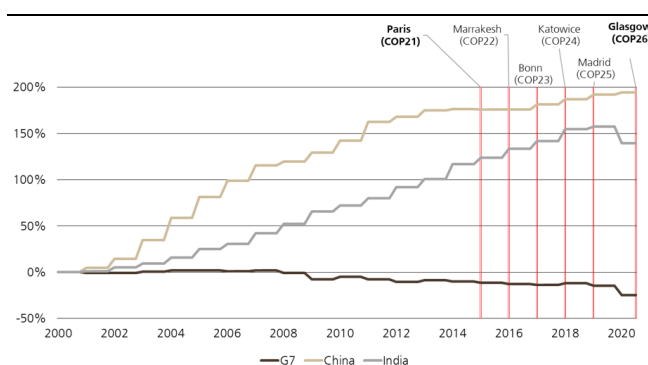
- **Coal Power Generation:** There has not been a reference to a timeline for the ‘phasing out’ of unabated coal power generation as advocated by many observers but it was the first time that the subject of fossil fuels has been included in a final COP decision. Countries have agreed to accelerate efforts towards ‘phasing down’ unabated coal power generation. This is already real progress and a move to phasing out can be expected in the future.
- **Fossil Fuel Subsidies:** There was a ‘call’ to end inefficient fossil fuel subsidies but no specification of a timeline. Apart from the phasing out of coal there was no reference or discussion with regards to other fossil fuels including oil and natural gas.
- **Carbon Markets:** An agreement on Article 6 of the Paris Agreement has finally been reached, laying the framework for global carbon trading. Some old credits will be permitted in the new system for a limited period of time. Voluntary emissions reductions may only be used towards a country's Nationally Determined Contribution if they are authorized by the UN. A fixed transaction tax of 5% on emissions trading will apply to the trading of voluntary emissions credits, not to national transfers.
- When it comes to *Climate Finance*, the COP recognized

that developed countries missed their target of providing USD 100bn per annum by 2020, but committed to raise at least this amount by 2025 and to ‘at least double’ Adaption Finance by 2025 to around USD 40bn annually.

In addition, several **announcements** were made at Glasgow:

- **Deforestation:** More than 130 countries, representing more than 85% of the planet's forests, pledged to end and reverse deforestation and land degradation by 2030. The agreement included some of the world's largest carbon stocks locked away in tropical forests.

Exhibit 1: Greenhouse gas emission commitments at previous COP meetings vs. COP26



Source: Bloomberg, UBS, as of November 2021.

- **International Sustainability Standards Board (ISSB):** The newly established Board will sit under the IFRS alongside the IASB. The standards to be developed by the ISSB can be used on a standalone basis or integrated into jurisdictional requirements, and the IFRS will introduce mechanisms for formal engagement with jurisdictions developing their own sustainability reporting requirements. The ISSB will consolidate the Value Reporting Foundation (VRF), which is home to SASB Standards and Integrated Reporting, and the Climate Disclosure Standards Board (CDSB).

- *Glasgow Financial Alliance for Net Zero (GFANZ)*: It includes the Net Zero Banking Alliance, UN Environment Program and the Net Zero Asset Manager Initiative and announced the progress in commitments of US\$130 trillion.
- *Network of Central Banks and Supervisors for Greening the Financial System (NGFS)*: announced that it will expand and strengthen its collective efforts to improve the resilience of the financial system to climate-related and environmental risks and encourage the scaling up of the financing flows needed to support the transition towards a sustainable economy.

Key questions from Central Banks and Sovereign Wealth Funds

The concepts of long-term investing and sustainability have become crucial for sovereign investors over the past years.

For central banks, the key principles of sustainability and long-term investing are in natural alignment with their objectives as sovereign investors, offering them not just the possibility to lead by example but also a potential source of alpha and a nontraditional framework to assess the risk/return of their investments in the context of their mandate and responsibility for their stakeholders.

And also for Sovereign Wealth Funds, over the last two years, there has been an acceleration when it comes to the integration of ESG into their investment frameworks. The number of SWFs joining the One Planet SWF Group has risen to eighteen, and one in five SWFs – according to the Global SWF GSR Scoreboard – has an ESG framework. This represents a good starting point for SWFs to gradually recognize that integrating sustainability can have a positive impact on the performance of listed asset classes and that there are growing opportunities in the green private market sector.

But there are various challenges in particular when it comes to the integration of climate-related investment strategies related to benchmarking, data availability and quality, as well as the operational integration of these vast amounts of data investment processes that are often centered around passive investments.

Therefore, what are the key questions we are hearing from sovereign investors in the current environment and following the Glasgow meeting?

- 1) **What changes might Glasgow cause to a Paris-aligned (PAB) sustainable portfolio? Are Paris-aligned benchmarks 'outdated' post-Glasgow?**

The main purpose of the Glasgow / COP26 meeting was about country-level contributions to achieve or move closer towards reaching the 2015 Paris Agreement goals since the current trajectory of global warming is still clearly above the 1.5°C scenario. The purpose of Glasgow was not about replacing or changing the Paris goals themselves but to ask governments to tighten their **Nationally Determined Contributions (NDCs)** as current commitments are insufficient.

Heading into COP26, 149 countries representing just over 80% of global greenhouse gas emissions had submitted new or updated NDCs. Another 47 countries representing less than 20% emissions did not. In total, 87 countries representing 63% of global emissions tightened their reductions relative to their initial targets. In addition, 82 countries and regions, representing ¾ of global emissions have pledged to drive their net emissions to zero by 2050.

The **PAB** is an **investment benchmark** that has been designed by the European Union to help inform investors who wish to align the carbon footprint and other characteristics of their portfolio with a Paris-aligned pathway. For investors that use Paris-aligned benchmarks (PAB), it is important to know that PAB is already 1.5°C aligned, and therefore any tightening of COP 26 targets will bring the national objectives simply closer to the PAB standard where 1.5°C is already incorporated.

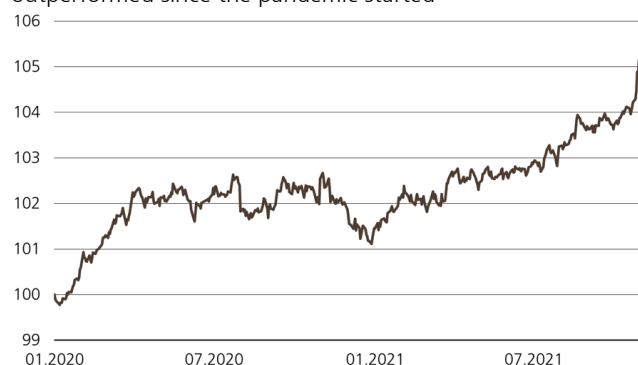
2) **What has been the recent performance of ESG strategies in general and Paris-aligned benchmarks in particular? Did the recent rise in value stocks affect performance?**

Investors have already realized for quite some time that ESG-focused investing does not have to mean accepting lower returns. Since early 2020, ESG indices like the **MSCI AC World ESG Leaders Index** have outperformed their non-ESG counterparts (MSCI ACWI Index). (See Exhibit 2.) This outperformance is remarkable because the period was not only marked by the dominance of technology shares (which often have strong ESG ratings) but also a rebound in value and energy-related names in 2021.

With regards to climate specifically, in the **equity** space, Paris-aligned benchmarks (PAB) also tend to consistently outperform their traditional counterparts (e.g. the MSCI AC World PAB since its inception 2014). Even with the recent oil rebound in the third quarter, the index is still outperforming in 2021YTD.

PABs indices tend to have a slightly lower dividend yields than their non-PAB counterparts, and, as systematic bias for such indices, higher PE & forward PE as well as higher price/book ratios. Also, turnover of these indices is about 4x higher, and the Tracking Error is about 100+bps, with similar volatility.

Exhibit 2: Relative performance MSCI AC World ESG Leaders vs MSCI AC World - ESG Leaders have outperformed since the pandemic started



Source: Bloomberg, UBS, as of November 2021.

In fixed income, the Global Aggregate Sustainability Index launched in 2013 shows a similar performance as the main Global Aggregate Index. For PAB specifically, indices are still emerging and have a limited track record when compared with equities. The concept of PAB is pretty new for the fixed income space and indices were typically incepted in 2020 or 2021. Until now, they show a performance that is broadly similar, with a slight tendency to underperform over this short observation period. The EUR IG Climate Paris Aligned Corporate Bond Index is an example.

3) Post Glasgow, what will be the key drivers in pushing the global climate agenda ahead?

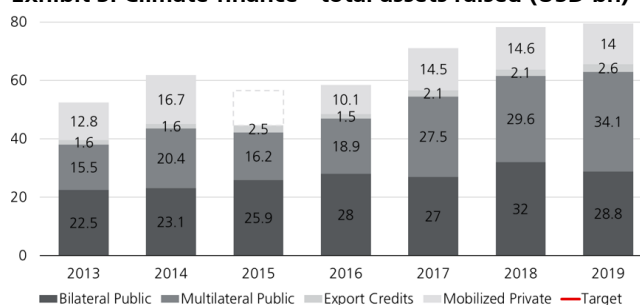
In 2022, the IPCC plans to publish the Synthesis Report (SYR) of its Sixth Assessment Report products, in time to inform the Global Stocktake of commitments under the Paris Agreement. COP27 is then expected to establish the ground for this first Global Stocktake. In this process, countries will review their progress towards the Paris Agreement goals, including the goal of keeping global warming to well below 2°C while pursuing efforts to limit it to 1.5°C.

Beyond these supranational bodies, we also expect further actions by governments, investors, and businesses. There will be winners and losers, but also profitable megatrends and investment opportunities along the line.

First, **national governments** are taking steps to reduce emissions through regulation and spending. As part of his fiscal package, President Joe Biden has won Congressional approval for substantial investments in clean energy, with spending on buildings, transportation, electricity, and agriculture. The US Securities and Exchange Commission is planning to require companies to disclose more about their greenhouse gas emissions and climate change risk management plans. The EU has rolled out its 'Fit for 55' target

to decarbonize the economy and proposes phasing out new combustion-engine passenger vehicles by 2035. The UK plans to do so by 2030. China wants all new cars to be either hybrids or new-energy vehicles by 2035.

Exhibit 3: Climate finance - total assets raised (USD bn)



Source: OECD, UBS, October 2021.

Government green funding is also a critical starting point and can help seed additional private sector investments. But the green agenda is also experiencing rising **private sector investments** and is therefore becoming less reliant on policy support alone. Global sustainable investing assets are now exceeding USD 35 trillion, or 36% of total institutional funds, according to a recent report from the Global Sustainable Investment Alliance, an increase of 15% in two years. Global renewable capacity has been increasing on average by 12% annually over the past decade.

The recent dialogue between China and the US also points to a potential acceleration in decarbonization the two largest carbon emission emitters. China and India might have watered down the deal with regards to the 'phasing' out of coal given their strong dependency on this fossil fuel. But ultimately the decline in the usage of coal appears inevitable for those countries as well.

Finally, **consumer** preferences are guiding businesses toward lower-emission products and services as can be seen in the growing demand for electric vehicles. Despite cuts in subsidies from the government, Chinese consumers bought 1.79 million electric vehicles in the first eight months of 2021, a rise of 194% from the prior year, and compared to a rise of just 14% in overall vehicle sales.

4) What other best practices are we currently discussing and observing when it comes to investing in climate-conscious products?

- Do not settle for exclusion-only strategies if you want to make a difference in the climate space. A key trend which is already ongoing is the move from exclusion to tilting to **stewardship/engagement** programs.

- Use **transition metrics**: Measuring the alignment of a portfolio with a net zero scenario should focus more on bottom-up approach (by looking at individual trajectories vs. benchmark to analyze what they should do – this gives an indication who has the better curve vs. the sector) as well as forward-looking assessments of how well management teams are tackling climate change and what innovations they are relying on. This calculation can be enhanced with **commitment scores** for example for companies that report properly and consistently.
- Get ready for incorporating the difficult part of carbon emission assessment '**scope 3**', i.e., **indirect emissions** as these will be phased in by regulators sooner or later, most likely around 2023.
- Always have '**impact measurability**' in mind – ask asset managers for metrics / proof of climate friendliness claims.
- Sovereign investors and in particular central banks are often fixed income-heavy investors with a focus on government bonds. For these, it is advised to have a policy on how to look at **sovereign emissions** (which can be measured e.g., as reduction of emissions per capita, or emissions per unit of GDP). In this context, government bonds are tricky to assess. We advise asking your asset managers to disclose how they treat government bonds and how they assess **climate risk** in this context. Is this measure based on tax income affected by climate? The frequency of natural disasters? Or infrastructure resilience in countries that for example have dams?
- Avoid the risk of '**double counting**', which however can be avoided if a portfolio is set up properly. If several tilting and exclusion strategies are combined, the order is important. If for example 20% of low ESG performers are excluded first, this will also affect some heavy CO₂ emitters, for example oil companies. Removing these first and then applying a climate-focused policy would lead to a higher total exposure to such strategies than had this exercise been done with the initial pool.

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Published November 2021.**

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