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A focus on climate can achieve multiple investor goals

A rules-based fixed income approach



UBS

Introduction

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Many investors want to mitigate the risks associated with climate change while simultaneously gaining exposure to companies that may benefit from such structural change. A rules-based investing strategy can play a key role in meeting such varied investor objectives, argue Emily McDonald, Clyde Fernandes and Rodrigo Dupleich.

We believe rules based strategies offer a compelling approach to climate investment by efficiently harnessing large and complex data sets to deliver broad market exposure, while minimizing unintended biases. Their systematic nature ensures transparency, consistency, and cost effectiveness – key advantages in navigating the evolving climate investment landscape – and takes into account the application to fixed income.

The role of fixed income in financing the transition should not be underestimated. Many investors have taken an ‘equity first’ approach when considering their sustainability objectives. However, climate risk is not exclusive to equities and can impact other asset class exposures, so they need to be considered. This includes providing debt finance (sometimes larger than equity finance) to companies in energy or materials sectors that have the expertise in managing the complexity, size and logistics of renewable energy, efficient energy or carbon sequestration projects.

For investors, the role of fixed income for climate aware strategies is also important given that bonds can play an important role in stabilizing returns in multi-asset portfolios.

Investors are increasingly using fixed income rules-based strategies as they seek to mitigate climate risk and take advantage climate-related opportunities. These strategies, similar to their equity equivalent, assess current and expected carbon emissions, the likelihood of companies meeting carbon targets, and apply qualitative overlays. In our view, this should form the basis of a climate tilting methodology.

While rules-based climate-aware strategies aim to maintain a low tracking error to a standard benchmark, fixed income strategies must consider more dimensions than equity strategies, such as duration, yield curve, subordination and ratings. This necessitates careful implementation of positive and negative climate tilts. There are a number of key factors for both climate aware and fixed income that need to be considered.

Optimizers and tilts

Portfolio optimization is an often-employed quantitative method used to select an appropriate mix of investments, with the aim of finding a balance between expected returns and risk. Increasingly, investors are choosing to include climate risk in addition to other traditional dimensions in their portfolios.











For bonds, the utilization of a proprietary optimizer works most effectively with a smaller subset of an index. For this reason, it is best to execute a tilt within the subset of the most climate sensitive sectors. This is the most appropriate subset of an index for the application of positive and negative tilts, as it can provide exposure to both transitioning companies and solution providers.

It is important to carefully calibrate the application of tilting within a fixed income strategy. This is because tilting may introduce unwanted distortions. For example, given current climate data, the application of a tilt in a strategy to the utility sector may overweight exposure towards EU issuers vs. US issuers, given that EU-based utilities generally have stronger climate credentials than their US counterparts, driven by stricter regulations, faster coal phase-outs, and greater investment in renewables. And, given that EUR denominated utilities bonds tend to be lower in duration than USD denominated bonds, this can introduce unwanted yield curve risk. A qualitative overlay can help to neutralize these types of risks. This is a key component of a low tracking error tilting strategy. Equally important is sufficient issuer liquidity, especially when considering positive tilts. As such, adding a cap to avoid overweighting issuers with limited issuance outstanding can help.

Focusing on a smaller subset of the investment universe can help to avoid excessive turnover and associated transaction costs; something more important for fixed income assets than equities.

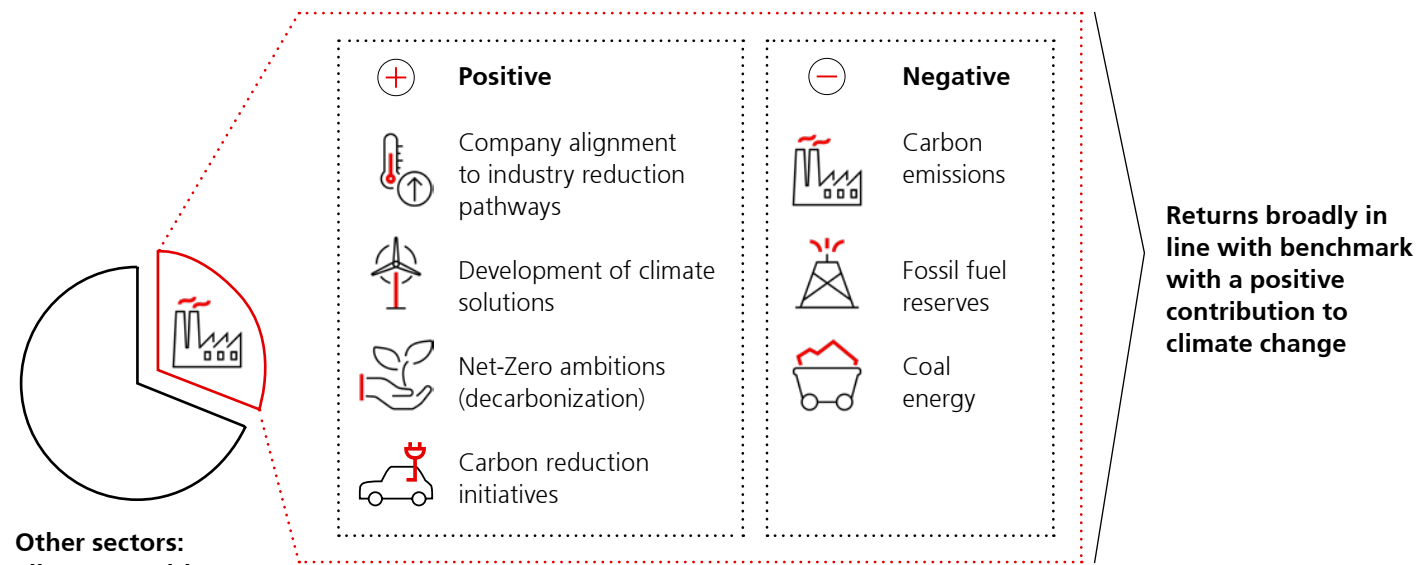
We find these sectors are generally the most climate sensitive

Barclays Capital level 4 industry classification

	Electric		Aerospace/Defense
	Automotive		Transportation Services
	Midstream		Chemicals
	Diversified Manufacturing		Natural Gas
	Integrated		Railroads

Climate sensitive sectors defined with reference to International Energy Agency (IEA) industries and associated climate scenarios and mapped to related industries in Global Industry Classification Standards (GICS), Industry Classification benchmark (ICB).

Positive and negative tilts applied to climate sensitive sectors



Other sectors: alignment with benchmark risk / return characteristics

UBS Asset Management: for illustrative purposes only.

Global corporate fixed income universe (~16'000 bonds across ~2'000 issuers)

Transitioning improvers

As well as presenting many risks across sectors and geographical regions, climate-related adaptation and mitigation can present compelling investment opportunities.

A rules-based strategy can employ both positive and negative tilts to companies, allowing a strategy to overweight companies that are contributing constructively to the energy transition while underweighting companies that are likely to have less impact. This approach can target companies that are developing green technologies as well as heavy polluters that are transitioning their business models in a positive way, even if that is not yet reflected in their current carbon emission disclosures because emissions data tends to be a lagging indicator. Given climate investing has a multi-dimensional perspective, a rules-based strategy should be designed to reference a range of data points in order to assess and execute a tilt. There are a number of key factors for both climate aware and fixed income that need to be considered.

Starting with a comprehensive universe that also includes carbon intensive companies that are investing in low carbon technologies may help capture additional opportunities. The number of constituents in a corporate bond index, such as the Bloomberg Global Aggregate Corporate Bond Index, is typically around 1,900 issuers and 16,000 securities, without wholesale exclusion of high emitters, can offer a broader range of issuers and sectors to select from.

This approach contrasts with the basic fossil fuel exclusionary approach at times adopted to achieve carbon emission reductions. As well as potentially causing a strategy to deviate significantly from a parent index exposure, a negative screening approach that targets fossil fuel related activities could limit exposure to sectors that are key to a successful global energy transition.¹



¹ The UBS AM standard ESG exclusion policy would apply <https://www.ubs.com/us/en/assetmanagement/capabilities/sustainable-investing.html>

Climate solutions, net zero, and carbon-reduction goals

A rules-based strategy can also include companies that provide solutions to the climate problem, such as those developing clean and efficient energy technologies. An additional tool is enhancing green bond exposure in a portfolio (vs. its minimal standard index weight). Rules based investment strategies that identify companies developing climate solutions may help towards the attainment of net zero by directing capital to these solutions.

Increasingly, investors expect companies to build climate transition considerations into their long-term business models. An effective method for evaluating whether they are doing this is to look at a company's current carbon footprint combined with its carbon reduction initiatives. This analysis can provide visibility into a company's expected future carbon reduction and allow for higher portfolio exposure to companies that appear most aligned to meet industry reduction pathways.

Forward looking assessments can incorporate the associated emission reduction implied by the 1.5°- or 2°-degree scenario and the probability of a company achieving that goal. Additionally, a qualitative overlay can capture the likelihood of success more comprehensively, for example through the consideration of Carbon Disclosure Project (CDP) scores, the quality of company policies and any other company initiatives related to carbon efficiency.

A quantitative model that combines a mixture of quantitative inputs and qualitative overlays can provide a richer understanding of an issuer's expected trajectory. The model can be used to tilt portfolios towards those companies most aligned to meet industry reduction pathways, managed against sector level data of 1.5°- or 2°-degree scenarios, in line with the Paris Agreement. The degree to which investee companies are likely to meet industry reduction pathways with respect to climate change can then be modelled and incorporated via increased and decreased exposure to index constituents.

Due to significant commitment to global initiatives such as the UN-convened Net Zero Asset Owners Alliance, there has been an increasing focus across the global investment industry on net-zero implementation practices. According to the latest information, the Net Zero Asset Owner Alliance (NZAOA) members represent AUM of USD 9.5 trillion, up from USD 8.4 trillion last year². This growth reflects the increasing commitment of asset owners to achieving net-zero emissions by 2050.

Rules-based climate portfolios can be complemented by a robust climate engagement program focused on positive outcomes for the climate transition. At UBS-AM we closely align and coordinate our climate engagement program with the climate factors used in investment strategies to ensure portfolio relevance is a priority of the program. This approach leverages both engagement efforts and investment decisions. Our climate program is in its seventh year with 67% positive progress against preset engagement objectives.

² <https://www.unepfi.org/themes/demonstrating-1-5c-aligned-decarbonisation-the-fourth-progress-report/>



Rules to live by

For fixed income investors who want to mitigate climate risks and are also seeking an optimal exposure to transitioning companies, a rules-based climate-aware investment strategy can be an attractive solution. Such an approach can accommodate net-zero alignment objectives and also maintain investment in sectors that are critical for the transition to a low-carbon economy.

A rules-based strategy can offer investors a comprehensive approach to climate investing and account for the complexities and nuances of a corporate fixed income universe.



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