19th October 2020

Delivering a Zero Carbon portfolio: 2 year anniversary

- In June 2018 we launched a Zero Carbon Portfolio for a university endowment fund
- The objective was to deliver the performance of a global equity index whilst fully excluding companies with exposure to fossil fuels and positively including Socially Responsible Investments
- In addition to a successful back-test, the live portfolio has delivered on objectives

What is Zero Carbon investing

The Zero Carbon Society at Cambridge University is one of many campaign groups calling for university endowment funds to divest from all fossil fuels. This has been termed "Zero Carbon" investing.

The divestment trend started in the US in 2012 when the city of Seattle divested from fossil fuels. In 2014, Stanford University followed suit. Campaigns across the US and UK led to other universities following suit. Some of the reasons universities found it hard to ensure that their investments were "fossil free" is because:

- Collectives: Use of collective investment schemes meant it was hard to pressure fund houses to change investment style, on something that would affect all clients
- Alternatives: Use of hedge funds and alternative strategies meant it was hard to vouch for full exclusion on a look-through basis
- Trackers: Use of low-cost tracker funds meant indirect exposure to energy stocks
- Definitional uncertainty: if you invest in a FTSE 100 future does that create "exposure"?
- Opportunity Set: Concern about a narrowing of the investment opportunity set
- Methodology: low carbon and ESG funds could nonetheless include energy companies with strong green credentials and substantial investment in renewable energy

The challenge

When set this challenge by a university college, we proposed to do two things. Firstly to create a Zero Carbon SRI benchmark to show how Zero Carbon investing could be done whilst also focusing on other ESG considerations. Secondly, to create a Zero Carbon portfolio to deliver on the primary aim of full divestment.

Creating a Zero Carbon SRI benchmark

We wanted to create a benchmark for the endowment's managers that not only screened out fossil fuels, but went further to screen out one of the main consumer of fossil fuels, the Utilities sector, as well as other extractive industries – namely the Materials sector. We also wanted to screen in companies with high ESG scores and low controversy risk and cover the global equity opportunity set. We worked with MSCI to create a custom index, the catchily-named (for taxonomy reasons) the **MSCI ACWI ex Energy ex Materials ex Utilities SRI Index** (the "Custom Index", please refer to Notices).

Creating a Zero Carbon portfolio

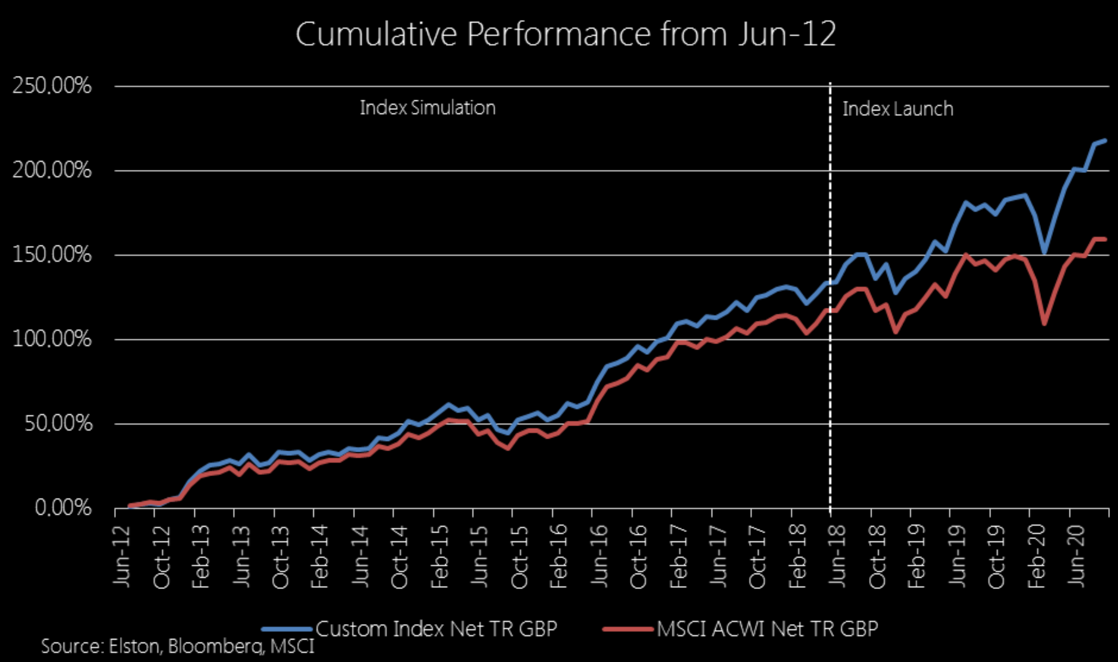
The second part of the project was to create an implementable investment strategy that maintained a similar risk-return profile to World Equities, but fully excluded the Energy, Materials and Utilities sectors. Rather than creating a fund which introduces additional layer of costs, this was achievable using sector-based ETF portfolio.

This portfolio meets the primary objective of creating a Zero Carbon, fully divested, world equity mandate. In the absence of ESG/SRI sector-based ETFs, it is not yet possible to create a sector-adjusted ESG/SRI ETF portfolio. But we expact that to change in the future.

Custom Index Performance

The back-test of both the custom index could deliver similar risk-return characteristics to global equities. The concern was would those back-test results continue once the index and portfolio went live. The answer is yes. Whilst the custom index has shown outperformance, that was not the objective. The objective was to access the same opportunity set, but with the fossil-free, ESG and socially responsible screens in place.

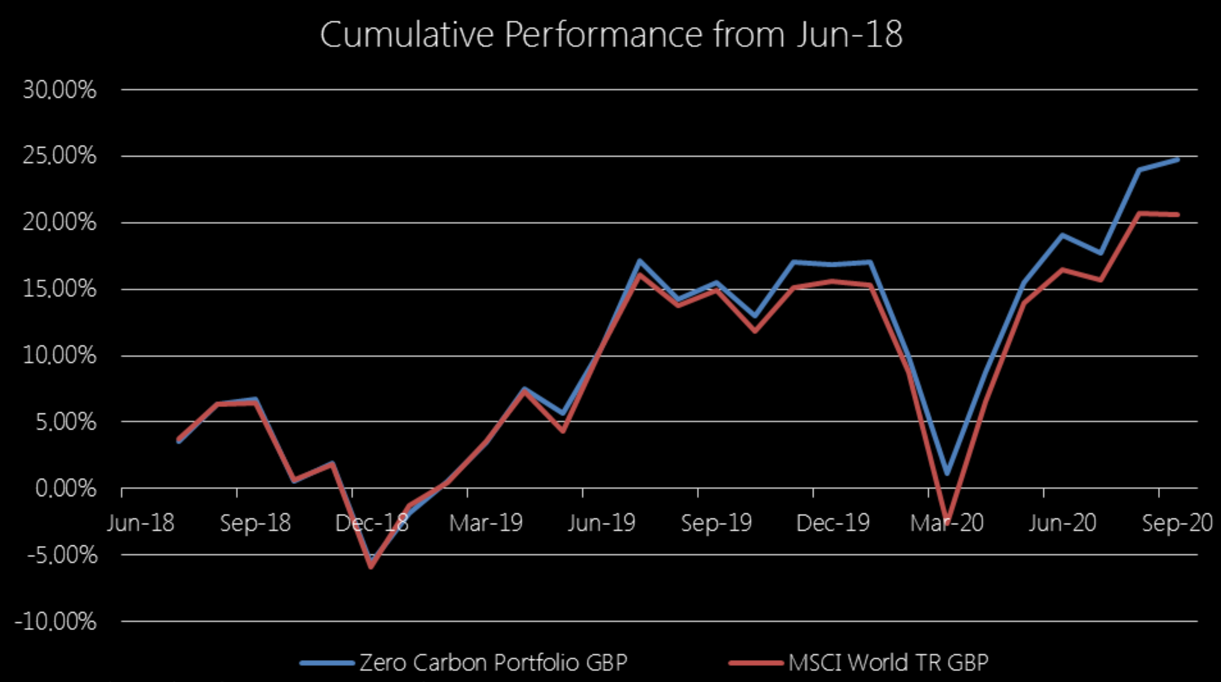
Fig.1. Custom Index performance simulation from June 2012 & live performance from June 2018



Zero Carbon Portfolio performance

Similarly, the Zero Carbon portfolio has delivered comparable performance to MSCI World – hence no "missing out" on the opportunity set whilst being fully divested from fossil fuels. Although not intentional, the exclusion of Energy, Materials & Utilities has benefitted performance and meant that the performance, net of trading and ongoing ETF costs, is ahead of the MSCI World Index.

Fig.2. Zero Carbon ETF portfolio performance from June 2018



Source: Elston, Bloomberg, MSCI, Manager data

Summary

Whatever your views on the pros and cons of divestment, Zero Carbon investing is not an insurmountable challenge, and the combination of index solutions and ETF portfolios solutions creates a range of implementable options for asset owners and asset managers alike.

Find out more

For more insights and information on research, portfolios and indices, visit:

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