The 'Magnificent' Performance of Climate Index Strategies

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As the strapline for the 1960 Yul Brynner Western (almost) goes… "*They were seven…. THEY ~~FOUGHT~~ PERFORMED LIKE SEVEN HUNDRED*". Global stock markets have been dominated this year by just seven US tech companies. The 'Magnificent Seven': Apple, Microsoft, Meta, Amazon, Alphabet, Nvidia and Tesla, have been responsible for "*all of the gains in global stocks*"[1] throughout 2023 so far, due to investor projections about the prospects for Artificial Intelligence.

This is a much-reported topic and we do not intend to add to the commentary on these stocks in particular – but, this 'Magnificent Seven' phenomenon has an important but so far under-reported consequence that we think is worth investor attention.

We have published a series of research whitepapers focusing on the use of climate data in portfolio construction. We have shone a light on the unintended consequences that can occur from a passive or systematic use of climate data, when expert risk management oversight is not employed. This research has led us to conclude that so called, 'passive' Paris alignment is not realistically achievable, and that investors in climate index strategies can be exposed to unintended and unmanaged risks.

This year's Magnificent Seven story offers another illustration of some of these risks, being:

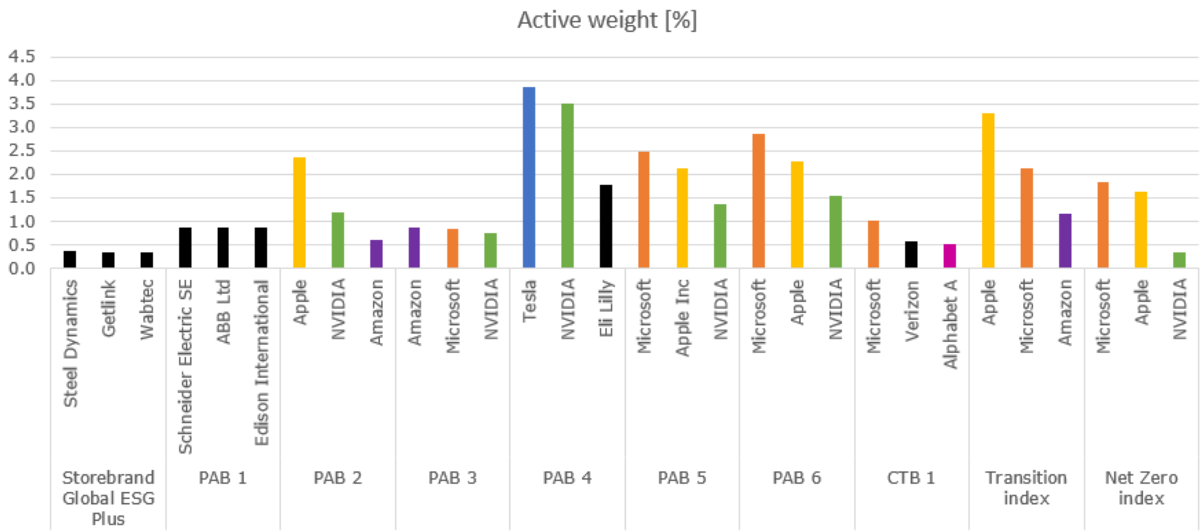
1) Individual stock and sector risk, which generally goes against the intention of passive investors.
2) A failure of Paris Aligned Benchmarks to meet one of their stated goals of "*reallocat(ing) capital to climate-friendly investments*".[2]

We can illustrate this by looking at the top overweight positions, relative to the global market / investment universe, for climate index strategies. It is worth noting that the top holdings of all these strategies will look broadly similar, if sorted by market capitalisation, as they are based on global market cap weighted indices which do not tend to vary much according to index brand[3]. However, investors in climate index strategies tracking new benchmarks, such as the EU defined Paris Aligned Benchmark (PAB) or Climate Transition Benchmark (CTB), could reasonably expect their active positions vs the parent index (top overweights and underweights) to be related to climate risk. Ultimately the active share and active positions are a measure of difference to the parent benchmark and show where the active risks from selecting those climate indices reside.

[1] 'Magnificent Seven' tech stocks drive US equity domination to new highs (ft.com)
[2] Sustainable finance – minimum standards for climate benchmarks (europa.eu)
[3] Our research illustrates that the tracking error between different brands of global index is minimal.

Figure 1 charts the top 3 overweight positions of a range of climate index tracking strategies, alongside our own systematically managed climate aware equity fund, Storebrand Global ESG Plus.

Figure 1: Top three overweight positions of climate index strategies



Source: Storebrand analysis based on holdings as at 30.09.2023 from Morningstar of ETFs/funds tracking each index strategy. Active weights defined versus MSCI World (MSCI World + Korea part of MSCI ACWI for one strategy which includes Korea as part of its investment universe to avoid tracking error contribution from different geographies between strategy and market cap reference index). Note some of these climate indices use other brands of global market cap weighted index as the parent benchmark, not MSCI World.

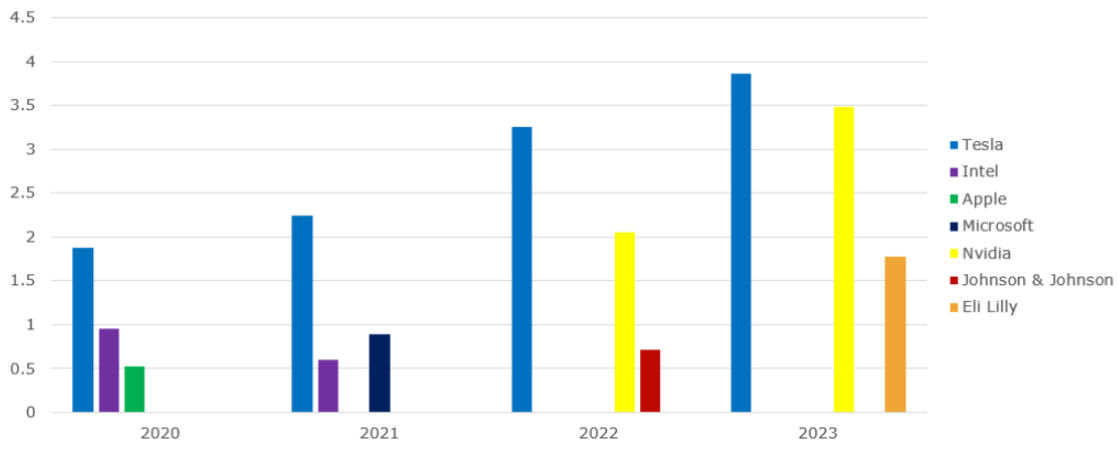
Black bars represent stocks that are not part of the 'Magnificent Seven', whereas 'Magnificent Seven' stocks have each been given a colour.

Our clients choose us as we aim to deliver 'climate beta', meaning our active positions, and as a result our performance relative to the MSCI World Index, are driven by climate change mitigation news and policy developments. Further, we minimise individual stock risk as we do not believe that investors seeking a replacement strategy for their passive global market cap equity portfolios desire stock specific risk. This is illustrated in Figure 1 which shows that the overweight positions of Storebrand Global ESG Plus are small, by design, and they are all in companies that we have designated as 'climate solutions' stocks.

Conversely, almost all of the climate index tracking strategies we have assessed, using a range of different index providers and methodologies, have relatively large overweights in the 'Magnificent Seven' stocks. Two thirds of these index tracking strategies have overweight positions of +2%, representing meaningful stock specific risk relative to the global market cap weighted benchmark. It is also worth noting that, although the majority of these index trackers are managed relative to indices which meet the same EU defined climate benchmark requirements, there is little consistency in their active positions. This means that the choice of which brand of 'Paris Aligned' benchmark to track makes a meaningful difference to the performance outcome.

The active positions of one of these Paris Aligned index trackers, which does not use risk optimisation and is called 'PAB 4' in Figure 1, have been growing every year – seemingly without a methodology that enables these stock specific risks to be identified and capped. Figure 2 shows the top three overweight positions for 'PAB 4' as at 30 September each year since 2020[4].

Figure 2 – 'PAB 4' top three overweights, increasing over time



Source: Storebrand analysis based on holdings as at 30.09.2023 from Bloomberg from ETFs/funds tracking each index strategy. Active weights defined versus MSCI World.

The stock specific risk of this particular Paris Aligned Benchmark has increased every year since inception[4]. The tracking error has gone from 1.35% relative to the 'parent' benchmark in 2020 to 3.27% in 2023[5]. The largest active industry position is being long technology, representing 0.80% of active risk.

Figure 3 shows how performance of the climate indices this year is linked to their positions in the Magnificent 7, resulting in outperformance relative to MSCI World (orange dot) for many. We judge the climate 'factor' to be negative in 2023[6] resulting from negative news flow on political back-paddling on climate ambitions[7], possibly related to inflation and the cost-of-living crisis. This is reflected in poor performance by climate solutions companies this year, and in high fossil fuels prices.

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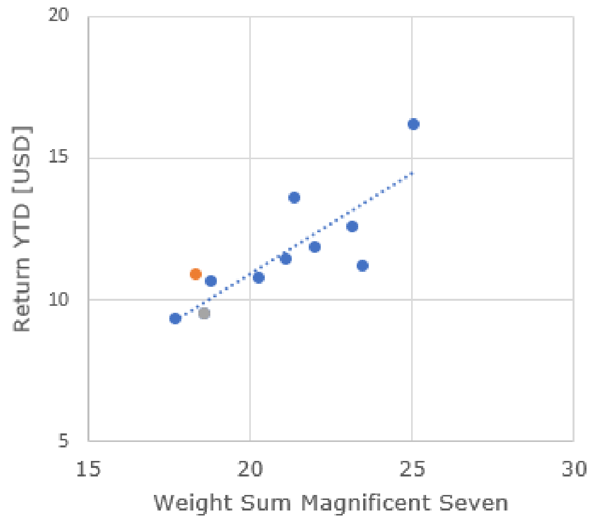
[4] Oldest available holdings in Bloomberg are as at 30.10.2020, reflected in 2020 figures. All other years are holdings as at 30.09.xx
[5] Ex ante tracking error calculated using Bloomberg's PORT factor model.
[6] Refer to Q3 Webinar (insert link) for Global ESG Plus including performance commentary
[7] The global backlash against climate policies has begun (economist.com)

Figure 3 – Return YTD vs weight in 'Magnificent Seven' Stocks, both as at 30 September 2023



Source: Storebrand analysis based on performance from Bloomberg of ETFs/funds tracking each climate index strategy. Note some of these climate indices use other brands of global market cap weighted index as the parent benchmark, not MSCI World. Blue dots are climate index trackers, orange dot is MSCI World, grey dot is Storebrand Global ESG Plus.

In Figure 3, we have plotted the return YTD as at 30.09.23 for each of the above-mentioned climate strategies (y axis) vs their total weight in the 'Magnificent Seven' stocks. There is a clear relationship between (better) performance and (higher) weight in the tech giants.

This year, the Magnificent Seven is responsible for the majority of the returns of the developed market benchmark, MSCI World, and accounts for a whopping 18.3% of the benchmark weight[8]. Astonishingly, the return of the Magnificent Seven alone was 55%.

At first glance some investors might be pleased with this Magnificent short-term outperformance of their climate index tracker - but it is worth reflecting on what this means in terms of risk. Active positioning relative to the market cap weighted index can go both ways - and if investors have chosen a climate index tracker to replace their passive market cap global equity index, they may be exposed to unintended but, crucially, unmanaged active risk. Further, those risks may be difficult to explain to beneficiaries if they are not aligned with expectations. Imagine if a similar approach could have led to a dot-com overweight in 2000 or a financials overweight in 2008. Unlike market capitalisation, there is no single measure of climate related financial risk on which all companies can be sorted meaning there is no truly 'passive' way of creating a climate related benchmark. Investors generally select climate index strategies in order to reduce their exposure to carbon intensive investments and to 'reallocate capital towards climate-friendly investments'. Importantly, they are chosen to

[8] Returns as at 30 September 2023 in USD.

replace their passive allocations tracking market cap weighted benchmarks. Investors choose passive strategies for transparency in outcome, plus a clear understanding of the risks they are exposed to and what will drive performance due to unquestionable methodological decisions around position sizing, at low cost. In practice, although the methodologies of these climate index strategies are readily available online and clear in their aims - exclude/reduce fossil fuel and value chain exposure, decarbonise portfolio scope 1-3 emissions intensity year on year, overweight companies with green revenues by x factor vs market cap etc – the financial outcome is far from transparent or attributable to ‘Paris Alignment’ or climate-related factors. There is no mention in climate index methodologies of increasing US mega caps or information technology exposure, and Tesla appears the only one of the Seven with a clear link to the climate transition opportunity.

Our analysis shows that, in practice, these climate index tracking strategies present substantial stock specific risks relative to the market cap indices they are designed to replace. Their resulting relative returns can therefore be driven by unexpected factors that are unrelated to climate change. These risks are often unintended, unmanaged and, as a result, can grow over time.

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