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ESG in Passive Investments

Whitepaper

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+44 (0)20 7832 6517
info@camradata.com
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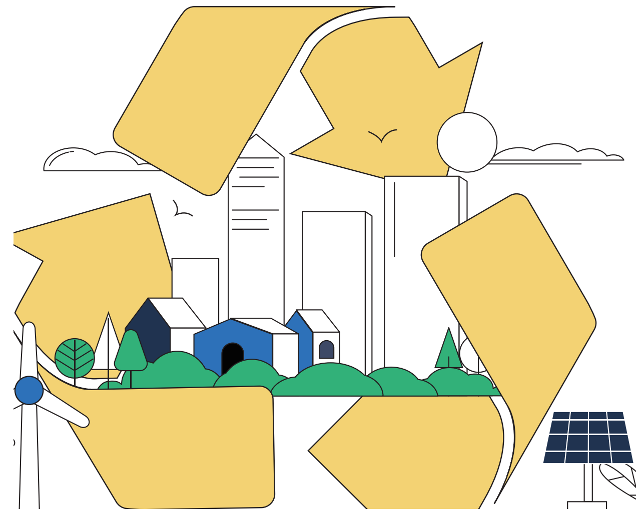


Contents

03 Introduction

05 ESG in Passive Investments Roundtable

10 Roundtable Participants

16 Northern Trust Asset Management

18 Storebrand Asset Management

Welcome to CAMRADATA's ESG in Passive Investments Whitepaper

Active asset management has been valiantly trying to hold its ground against the rising tide of indexing for over thirty years. With regard to public equities, it's been a losing game. Which does not mean that indexing has won without change. The factor revolution of the early 2010s brought forms of enhanced indexing back into favour. Exchange-Traded Products have successfully grown from stock baskets designed by brokerage houses' trading desks into the vehicles of choice for real-money thematic investing. The switch to Defined Contribution, individualised pension savings put an onus on costs which frustrates active management.

And then there is ESG in passive. It could not have happened without the other developments but has benefited from them all. Asset owners are happy to accept tracking error in order to meet climate change objectives. They are comfortable discussing a variety of methodologies. In part this is because of the rise of thematic investing; in part because everyone accepts that the underlying data (with the possible exception of governance) and their assimilation into investing is an ongoing process.

The philosophical question is how influential ESG-aware passive strategies should be. Thirty years ago index-trackers were clear that investing was a zero-sum game and they had no pretensions to challenge that fact. Introduce ESG criteria and it is evident that there are active decisions in capital allocation.

Optimisation allows for index-like returns with varying exposures to individual constituent companies. Are the CEOs of individual companies moved by these strategies? There are so many flavours of ESG, even from single asset management houses, that their influence can be hard to discern. Managers (and asset owners) make much of united campaigns and alliances but then spend billions of dollars attempting to differentiate their products. Some claim to be activists as stewards while others admit to being too small to affect large corporations, especially overseas.

This CAMRADATA whitepaper will attempt to discuss the role and nature of ESG-aware passive strategies.

Meet the Team

Natasha Silva
Managing Director, Client Relations

Amy Richardson
Managing Director, Business Development

Orin Ferguson
Associate, Business Development

Sarah Northwood
Marketing and Events Coordinator

Dorota Madajczyk
Senior Associate, CRM & Circulation Administrator

ESG in Passive Investments Roundtable

The CAMRADATA ESG in Passive Investments Roundtable took place in May 2024

Earlier this century passive investing got a twist when broad-market systematic strategies deliberately upped their tracking error to a standard benchmark. Commonly, the new strategies would accept an annualised deviation of anything up 50 basis points. They were described as enhanced indexing, sitting between traditional passive and active.

Today's emphasis on ESG criteria for investing brings new thinking to tolerance and the characterisation of enhanced indexing strategies. The 2024 CAMRADATA roundtable on ESG in Passive Investments began by asking consultants and asset owners about their clients' tolerance for tracking error in the latest iteration of enhanced indexing.

Sophie Fisher leads on Aon's UK sustainable passive equity Buy List. She said that ideally such strategies would be below 100 basis points, but her team does look at some with up to 200 basis points tracking error. "It really depends on client appetite," said Fisher.

For Isio, an adviser to UK pension funds, Georgia Lewis, sustainable investment consultant, said it did not have a catch-all threshold and would depend very much on clients' specific risk tolerance.

Martyn MacDonald, a senior investment associate at XPS, another adviser to UK pension funds, said it would not consider strategies purely from an ESG perspective. XPS has an ESG rating which forms a part of the analysis of all strategies put before clients by XPS, and the firm has also built up a buy list of sustainable funds which do go further to target sustainable themes. Whether or not a fund is sustainable, when it comes to strategies categorised as passive, MacDonald said XPS favours funds with tracking error around 25bps. However, he has seen some funds which have stronger sustainability targets that do allow tracking error up to 150bps.

Sonia Bluzmanis is the head of research, external equities at Rest Super, an Australian superannuation fund with around two million members and more than AU$80bn in assets under management. She noted that the Fund's regulator undertakes an annual performance test which has encouraged more benchmark-aware behaviour generally across Aussie Super funds.

Many customised passive equity strategies with ESG in their name track ESG indices rather than the market-cap index. The danger here is that customisation can lead to a wide variety in results. "

At the same time there are expectations from members of these funds to integrate ESG risk and climate risk. In the case of Rest Super, the core default fund, does not have an explicit ESG tilt, rather ESG integration is required at the underlying strategy level along with a reduction in Weighted Average Carbon Intensity (WACI) relative to the relevant market-cap index for systematic solutions.

Lauren Juliff, climate and sustainability product lead, head of UK institutional at Storebrand Asset Management, said that it was really important to understand against which index the tracking error is being measured. She noted that many customised passive equity strategies with ESG in their name track ESG indices rather than the market-cap index.

The danger here is that customisation can lead to a wide variety in results. Storebrand's own analysis of passive strategies tracking Paris-Aligned benchmarks (PABs) suggested a range of 150 to 500 basis points in tracking error. Juliff argued such variation demonstrated that in fact these strategies are all doing different things. She warned that fund selectors and asset owners have to be aware of the unmanaged risks and exposures ongoing within strategies offering headline decarbonisation.

One of the causes of variation is the different measurements of emissions for individual stocks. Juliff reckoned that associated emissions could be 25 times higher in some cases such as chipmakers, Intel and Nvidia, depending on what gets counted in their Scope 3 outputs. "There is no consistency in how data providers are estimating data gaps," she said. "But even if we did have standardised reporting of Scope 3 emissions, there is still a problem in how these are applied in portfolio construction."

Juliff gave the example of electricity grid operators and their suppliers. On the simple basis of Scope 3 emissions, they seem bad. But Storebrand sees them as climate-transition enablers.

For Northern Trust Asset Management (NTAM), Guido Baltussen, head of quantitative strategies, international, said that for most NTAM clients, the market-cap index was the reference for tracking error. "Custom ESG indices appeal to more and more clients but come with higher tracking error," he said.

Baltussen said NTAM had US$172bn in assets under management in sustainable investing strategies, including solutions related to the UN Sustainable Development Goals and transition pathways.

NTAM commonly executes clients' wishes for exclusions followed by proprietary optimisations on sustainable characteristics. Baltussen reckoned that 50-100 basis points was a fair range of the tracking error for clients in this type of strategy.

However, he emphasized the need to manage other sources of active risk that emerged with ESG integration. Weighting a portfolio solely according to a few sustainability measures could blind the manager and clients to fundamental concerns such as the expensiveness of the stocks. "You have to think about how you are using the risk budget," he said.

Bluzmanis noted that Australian Super funds were under a lot of scrutiny to deliver good outcomes after fees for members. If they fail the performance test over two consecutive years, the superannuation entity is prohibited from accepting new members into that product. This has led to industry consolidation and a drive to reduce costs. "Consistent relative performance outcomes have become more important," she noted. "ESG is a focus but decisions must be in the best financial interests of our members.

Bluzmanis added that ESG is not viewed solely as a risk but intertwined with positive outcomes. She said it was difficult trying to solve for many different things. Rest Super's average member is in the mid-30s. The fund has to be aware of how short-term squalls in financial markets affects these people's confidence in their pension provider.

On a similar note, Bluzmanis said that while WACI as a measure of carbon footprint, made reporting simpler, it doesn't tell us about the decarbonisation trajectory.

As part of their broader sustainability program, Rest Super also considers the fund's alignment with UN SDGs and has a target to invest 1% of its AUM in aligned impact investments, largely targeted at decarbonisation.

What is lost and what is gained

The CAMRADATA roundtable then discussed what ESG passive was replacing in asset owners' portfolios.

Fisher said the answer was market-cap passive as clients recognised in their own policies and sustainability targets such as Net-Zero Carbon. She added that Defined Benefit (DB) pension plans were also reducing active equity risk as they took the path to buy out of their liabilities or self-sufficiency, and so could turn to sustainable passive in this scenario.

For Isio, Lewis agreed that DB plans were moving away from active management. That move did not necessarily mean, however, that clients were headed for ESG passive.

MacDonald said that derisking generally led to more credit than equity. At the same time, across all asset classes, trustees were more minded to pick a sustainable equivalent to any traditional product. He foresaw some interest in ESG passive equity for those DB schemes that saw run-on as a better future than buy-out.

In an echo of Bluzmanis's comment on the attractiveness of a single figure for decarbonisation, MacDonald said that using market cap indices as the reference makes it easier and more efficient for manager researchers to compare funds.

Baltussen said he definitely saw a trend towards sustainable and passive in the institutional pension market. "But how can you have a balance between the three dimensions of risk, return and sustainability?" he asked. "You have to be careful on the risk dimension about macroeconomics and stock-specific risk; and keep in mind the ultimate financial objective."

Juliff said that Storebrand optimises the portfolio. Part of this process is about seeking greater exposure to climate beta. There is no universally recognised definition of climate beta but for Storebrand it necessitates overweights to companies that are "climate-positive" overall and underweights to companies that are climate negative. Juliff explained that the quantum of performance derived from climate solutions, ie green revenues, is explained to clients and prospects.

Baltussen noted that weighting by means of revenue can often be an anti-Value measure. He raised a concern that emissions are derived from firms' own reporting. And noted that investors are concerned about governance; how company leaders deliver on promises to the transition to a low-carbon future and green capex.

Juliff said that Paris-Aligned Benchmarks often ignored key tenets of the Paris Agreement, including the need for a just transition. She claimed that the Agreement's "common but differentiated responsibilities for developing countries" ought to be reflected in PAB methodologies with regard to Emerging Markets". Instead, Juliff gave examples of PAB methodologies that required Emerging Markets to decarbonise at the same rate as Developed Markets, and of investors that excluded Emerging Markets and cited portfolio decarbonisation as a 'co-benefit'.

The CAMRADATA panel thus began to expand to richer, more integral combinations of sustainability principles. Lewis said that Isio has a preference for Climate, Social and Nature themes but has yet to discover strategies that capture all three.

Regarding natural capital, Juliff pointed to Forest IQ, a new global database on deforestation exposure. Storebrand contributed to the development of Forest IQ and will apply it to its entire portfolio going forward.

On social and human rights she mentioned PRI

> ***"Rest Super has moved towards transition solutions. But these are harder to explain to stakeholders and members. Bluzmanis indicated that impact strategies could be more effective but there had to be accompanying education to explain the complexity."***

Advance, which is campaigning on human rights in value chains of sectors such as renewable energy.

Bluzmanis said that we all want better real-world outcomes. "Rest Super has moved towards transition solutions. But these are harder to explain to stakeholders and members," she admitted. When it comes to Nature, she said that Rest Super was working out what to do. But questions remain: "how do we measure Nature risk? Which kind of investments do we make?"

Bluzmanis indicated that impact strategies could be more effective but there had to be accompanying education to explain the complexity.

Looking forward

Fisher then spoke about the evolution of ESG in passive investing from exclusions to forward-looking methodologies. She said that exclusionary funds alone remain in some Aon client portfolios but they were becoming rarer.

Fisher added that broad-market ESG strategies were suitable for clients wanting to minimise tracking error to the market cap. There had been much product development here during the resurgence in factor investing in the last decade.

Fisher described Best-in-class as a combination of exclusions and broad market, which increases tracking error. Best-in-class generates a stronger signal to stakeholders, according to Fisher, given the broad approach across the sectors and the portfolio's more significant ESG profile enhancement.

When it comes to forward-looking strategies, Fisher said they align with scenario analysis and regulatory guidance, e.g. on Net-Zero Carbon emissions for companies, insurers and pension funds. This is a particular area which has been gaining client traction and Aon's DC master trust also uses forward-looking strategies, co-developed with asset managers.

Overall, Fisher said that Aon has streamlined its coverage by removing older indices from its sustainable index buy-list, and adding some newer, forward-looking funds. In this space the consultancy now uses just a few preferred managers too.

MacDonald said XPS does see similar approaches to the four categories described by Aon. However he generally looks for funds which utilise more than just exclusions, favouring tilting on ESG factors or forward-looking climate metrics. Rather than grouping funds by approach, XPS labels funds Sustainable or Impact depending on the extent to which sustainable objectives inform the decisions.

Lewis added that Isio spends a lot of time on investment approaches, ie the reporting capabilities of third-party managers; their voting records; evidence of stewardship and engagement. "These feed heavily into our ratings system," she said.

She noted that clients' stewardship priorities get documented in their Statement of Investment Principles, which then play a role in the evaluation of asset managers.

The managers are challenged on what Isio clients will get from their strategy. "We want to ascertain how aligned the prospective managers are to the client priorities," said Lewis.

"Climate issues clearly can trigger idiosyncratic events which could upset individual companies and such events were not acknowledged in some models. Green analysis is what makes a fund climate-aware,"

She noted that in a project for one major client, on examining its third-party managers' voting record versus holdings, practice by several fell short of their claims on engagement and stewardship. On the other hand, Lewis said that in her experience, if clients grumble, then managers will respond and look to improve their processes.

Lewis added that engagement had to be more sophisticated than mere divestment. Isio likes to see milestones as part of a manager's process of engagement.

MacDonald said that it was insightful to know how managers involved themselves in broader market initiatives on sustainability and single-company engagement.

On performance, Juliff said for Storebrand's Plus Fund range, the market-cap index is the comparison and the range gets managed to that.

Juliff pointed out that following a PAB methodology often led to a huge bet on mega tech stocks last year. Her worry is that clients do not see all the risks borne by simple tracking strategies; risks that will greatly affect performance.

Juliff said that pension funds choose passive as a low-governance option. That has worked in market-cap passive because there has been very little surprise [in the form of tracking error] demonstrated by the strategies. She said that the same cannot be said for strategies tracking ESG indices as their benchmark.

MacDonald observed that clients might find themselves better off as a result of such surprises. Juliff agreed that the gross overweight to mega tech had worked well. But that did not make it right for clients who bought the strategy as a means to decarbonise their investments or align them with the goals of the Paris Agreement.

The CAMRADATA panel returned to the meaning of Climate Beta. Fisher found the term useful for gauging those companies more sensitive to the energy transition. She noted that climate issues clearly can trigger idiosyncratic events which could upset individual companies and such events were not acknowledged in some models. "Green analysis is what makes a fund climate-aware," she said.

Bluzmanis said she was not sure whether Climate Beta means sensitivity to climate risk or to the Low Carbon economy, ie is it bad or good? "Picking that up systematically, ie how to measure it through the portfolio, is the difficult question," she said.

Juliff clarified that Climate Transition Beta cannot be universally acknowledged because there is not a simple pathway to alignment with the goals of the Paris Accord.

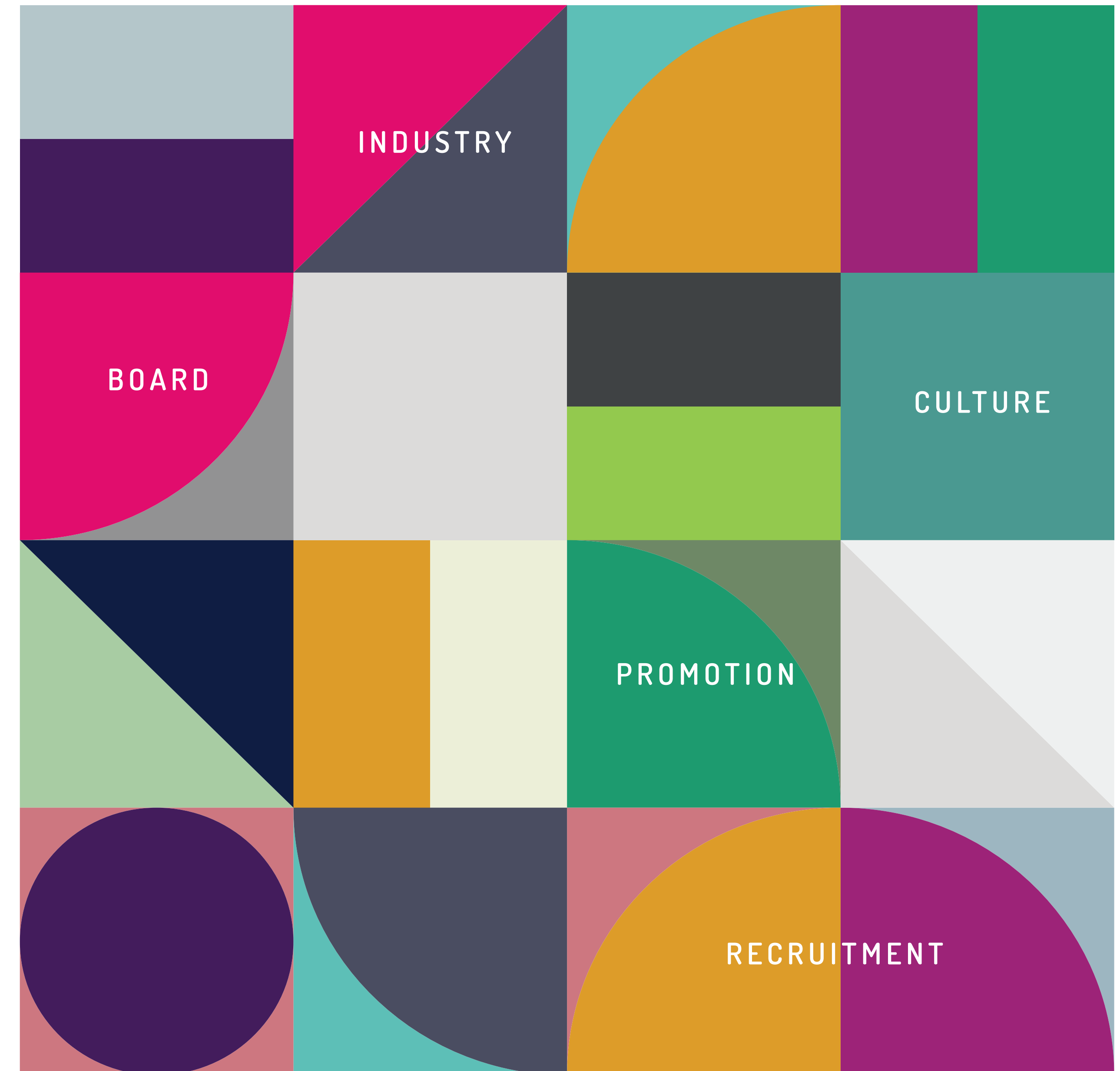
Fisher agreed that to meet Net-Zero Carbon targets, you have to invest in transition companies.

Juliff highlighted that allocating capital on the basis of corporate emissions reporting can lead to unintended consequences. "Emissions metrics alone are not always a great indicator of climate risk," she said. "For example, climate solutions companies often have high emissions due to the way that company emissions are reported - but this does not mean that they represent high risk when aiming to align investments with the Low Carbon transition.

"There is a huge risk of oversimplifying Climate Change and Implied Temperature Risk. This will take a lot of education," said Juliff. That includes managers' engagement with policymakers. She spends a lot of time responding to government consultations on decision-useful metrics in sustainability.

Bluzmanis said that that education and engagement was a job in itself. "Stakeholders want less information but this is challenging with more complexity in the job and multiple objectives.

When it comes to engaging on ESG matters we lean on managers more to do this at the company level," said Bluzmanis.



Diversity for asset managers is at a critical tipping point.

CAMRADATA now hosts the Asset Owner Diversity Charter within CAMRADATA Live, making it free to access for both asset owners and asset managers alike.

The Asset Owner Diversity Charter was formed with an objective to formalise a set of actions that asset owners can commit to improve diversity, in all forms, across the investment industry. It seeks for signatories to collaborate and build an investment industry which embodies a more balanced representation of diverse societies.

info@camradata.com

Roundtable Participants

Guido Baltussen, Ph.D

International Head of Quantitative Strategies

Personal Profile

Guido Baltussen, head of quantitative strategies, International at Northern Trust Asset Management leads international quantitative strategies investments to support the firm's growth, including quantitative research and innovation, thought leadership and investment strategy.

Prior to joining Northern Trust Asset Management in 2023, Guido was head of equity factor investing and co-head of quantitative fixed income at Robeco.

Guido is a professor of finance at Erasmus University in Rotterdam. He holds a Ph.D. in finance from Erasmus University Rotterdam and an M.Phil. in economics from the Tinbergen Institute. An accomplished researcher, Baltussen has published in journals such as the American Economic Review, the Journal of Financial Economics and the Financial Analysts Journal.

Company Profile

Northern Trust Asset Management is a global investment manager that helps investors navigate changing market environments in efforts to realize their long-term objectives.

Entrusted with $1.2 trillion in assets under management as of March 31, 2024, we understand that investing ultimately serves a greater purpose and believe investors should be compensated for the risks they take — in all market environments and any investment strategy.

That's why we combine robust capital markets research, expert portfolio construction and comprehensive risk management in an effort to craft innovative and efficient solutions that seek to deliver targeted investment outcomes.

Lauren Juliff

Climate and Sustainability Product Lead, Head of UK Institutional

Personal Profile

Lauren is a climate change specialist and a product specialist on the Storebrand Plus Fund range.

She is responsible for working with clients on their sustainability goals, specifically how Storebrand can develop and deliver tools to help clients meet and demonstrate progress on their goals. Lauren joined Storebrand as part of the SKAGEN merger in 2018.

She joined SKAGEN in 2013 as Head of UK Institutional and has over 20 years' experience working with UK institutional investors. Previously Lauren was Head of DC Business Development at Schroders, she joined the financial services industry with Fidelity International in 2001. Lauren has a BSc (hons) in Mathematics from the University of Leeds and an MSc in Climate Change: Environment, Science and Policy from King's College London.

Company Profile

Established in 1981, Storebrand Asset Management (SAM) is part of the Storebrand Group (Storebrand ASA), which is listed on the Oslo Stock Exchange and has roots back to 1767. SAM is the largest private asset manager in Norway, providing a range of investment services to over 300 institutional clients and managing approximately £93.6bn across all asset classes, including £1bn on behalf of UK pension schemes.

Sustainability is integral to SAM's business, and we give considerable weight to ESG considerations before making investment decisions. We were the first Norwegian company to establish a sustainable investment department in 1995 and have one of the most experienced ESG teams in the Nordic region.

SAM was a founding signatory of the UNPRI and has been included in the PRI Leaders' Group since 2019. Storebrand ASA is a member of the Dow Jones' Sustainability Index and is on the CDP Climate A List.

Roundtable Participants

Sophie Fisher

Associate Investment Consultant, Equity Manager Research

Personal Profile

Sophie Fisher joined Aon's Global Investment Management (GIM) team as a graduate in September 2021. Sophie researches equity investment managers and provides advice and recommendations across Global, Emerging Markets and UK equity managers.

Sophie has a focus on Sustainable and Impact equity strategies and leads on Aon's UK sustainable passive equity Buy List. Sophie also sits on Aon's manager research DE&I working group.

Prior to joining Aon, Sophie studied Politics and Economics at Newcastle University, and she has passed the IMC and the CFA Certificate in Impact Investing.

AON

Georgia Lewis

Sustainable Investment Consultant

Personal Profile

Georgia is a Sustainable Investment Consultant within Isio's Sustainable Investments team, largely working on client advice including TCFD reporting for a number of large DB, DC Master trust and LGPS schemes, as well as deep-dive client research projects.

She also contributes to Isio's manager and fund research within the industry, with a focus on Social Factors.

Georgia regularly delivers climate and broader SI training to clients as well as to internal stakeholders. Georgia has been at Isio for 3 years and has 5 years of industry experience.

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Sonia Bluzmanis

Head of Research, External Equities

Personal Profile

Sonia is the Head of Research, External Equities at REST, based in London. Sonia joined REST from BT Investment Group in May 2021, initially to take on the role of Head of Global Equities, with responsibility for managing REST's 20Bil+ global equities asset class, the fund's largest asset class by funds under management. In 2022 Sonia relocated to London and was promoted to Head of Research, External Equities to lead the equity research program, providing advice on manager selection and construction, and market insights.

With over 17 years' experience in investment management, Sonia has held senior roles specialising in investment research, fund manager selection and portfolio construction in several major financial institutions. Sonia holds a Bachelor of Commerce and a Bachelor of Arts (Asian Studies), with majors in Finance, Economics and Chinese (Mandarin) from Curtin University in Western Australia and holds the Certified Investment Management Analyst (CIMA) designation.

Established in 1988, REST is among the largest superannuation funds in Australia by membership, with approximately 1.9 million members and over AU$80 billion in assets under management.

Rest

Martyn MacDonald

Senior Investment Associate

Personal Profile

Deputy head of the XPS Investment Credit team, with a focus on Private Credit.

Member of the XPS ESG and Multi Asset research teams.

4 years industry experience.

University of Glasgow graduate with an Aeronautical Engineering MEng.

XPS Investment

Moderator

Brendan Maton

Freelance Journalist

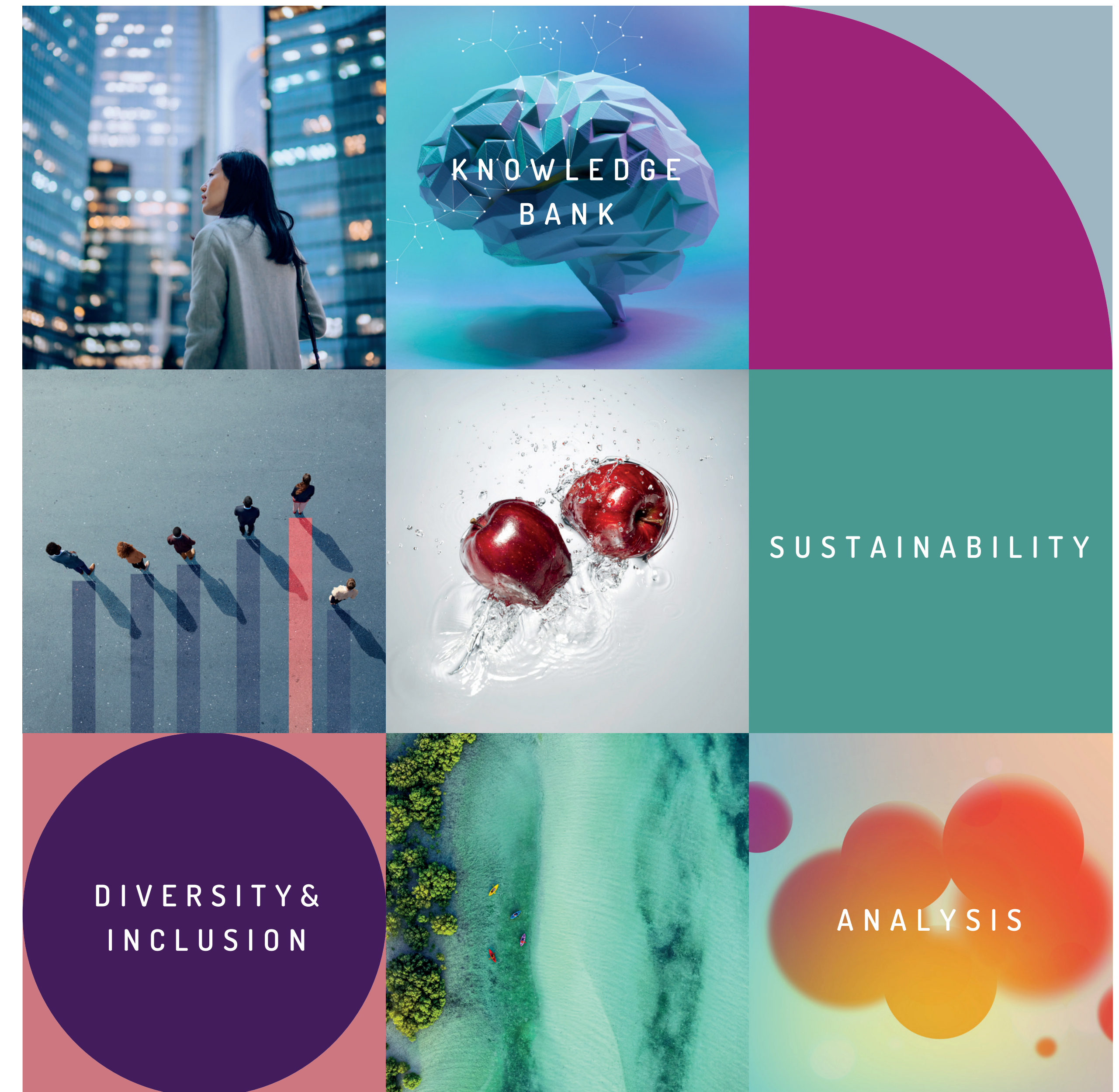
Personal Profile

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.

Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.



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Lauren Juliff, Climate and Sustainability Product Lead and Henrik Wold Nilsen, Senior Portfolio Manager and Climate Change Specialist have produced a number of white papers on the use of climate data in portfolio construction and some of the unintended consequences that can occur for investors.

Please visit the "Climate Data Discussions" section of our website, for a full list of their papers, or scan the QR codes below for a selection of recent publications:

The Magnificent Performance of Climate Index Strategies

In this commentary we look at the top overweight positions of climate index tracking funds relative to the market cap weighted index and find that almost all of them have relatively large overweights in the "Magnificent Seven", representing meaningful stock specific risk. We find a positive relationship between the performance of climate index funds and their positions in the Magnificent 7 stocks throughout 2023 and question whether this is aligned with the objectives of investors seeking "passive" global equity replacement strategies or exposure to the climate transition opportunity.

The Paris Alignment Paradox: Scoping Out Solutions

Despite their laudable aims to avoid "counterintuitive results", "prevent greenwashing" and "reallocate capital towards climate-friendly investments", Paris aligned index strategies often lack meaningful exposure to climate solutions. Our analysis shows the inclusion of scope 3 data provides a sub-optimal indication of portfolio climate risk exposure and can cause perverse allocation decisions by investors.

The Climate Data Conundrum

As climate reporting regulations for investors increasingly require 'Scope 3' data, we look at the consequences of using this data in portfolio construction. We find that climate solutions companies are the largest sources of scope 3 emissions in our portfolio and use the example of heat pumps to explain the concept of 'Scope 4', or avoided emissions. The use of carbon emissions data by Scope and sector requires nuance and specialist oversight and a failure to consider Scope 4 emissions at a top level can prevent investments in climate positive solutions. A discerning view of emissions data, and oversight by a climate specialist portfolio manager allows us to spot these unintended consequences that might occur in 'passively' managed solutions such as climate indices.

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Storebrand Asset Management UK Ltd (SAM UK Ltd)
15 Stratton Street, London W1J 8LQ, United Kingdom

Storebrand Asset Management Headquarters
Professor Kohts vei 9, 1327 Lysaker, Norway

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With Intelligence
One London Wall
London
EC2Y 5EA

+44 (0)20 7832 6500
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