There's Nothing Passive About Net Zero in Fixed Income

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Key Takeaways

- Our view is that bond investors who are concerned about the potential for climate change to cause extraordinary market dislocation in the future need to be proactive today.
- Many long-term investors are considering strategies to transition portfolio holdings to net zero greenhouse gas (GHG) emissions by 2050.
- Breckinridge believes net zero investing demands a strong sense of stewardship, engagement, and collaboration.

Breckinridge believes there is a solid investment case for long-term investors to transition portfolio holdings to net zero GHG emissions by 2050, consistent with global ambitions to limit global warming to 1.5 degrees Celsius above pre-industrial levels.

We believe that climate transition risks are not adequately assessed, or priced into many investments and, that the financial materiality of these risks will only increase over time. In conversation, we have found that corporate bond investors, including pensions and endowments, who are responsible for the reliability of future cash flows are particularly focused on the evolving risks and opportunities associated with a low- or no-carbon economy.

We also believe net zero investing demands a strong sense of stewardship, engagement, and collaboration.

For investors taking the added step of committing to reduce portfolio emissions intensity, passive investing and divestment are too blunt an instrument, in our view, and leave the due diligence (and opportunities) to active capital.

It is our conviction that net zero is not a passive investment endeavor. Indeed, we think net zero investing requires an active management approach. Investors who are concerned about the potential for climate change to cause extraordinary market dislocation in the future need to be proactive today.

In this commentary, we review some traditional passive approaches and what we consider to be intrinsic limitations within a net zero framework. Then we discuss Breckinridge's process and why we believe an investment process that comprises a strategy based on proprietary analysis and active portfolio management is better aligned for a net zero framework.

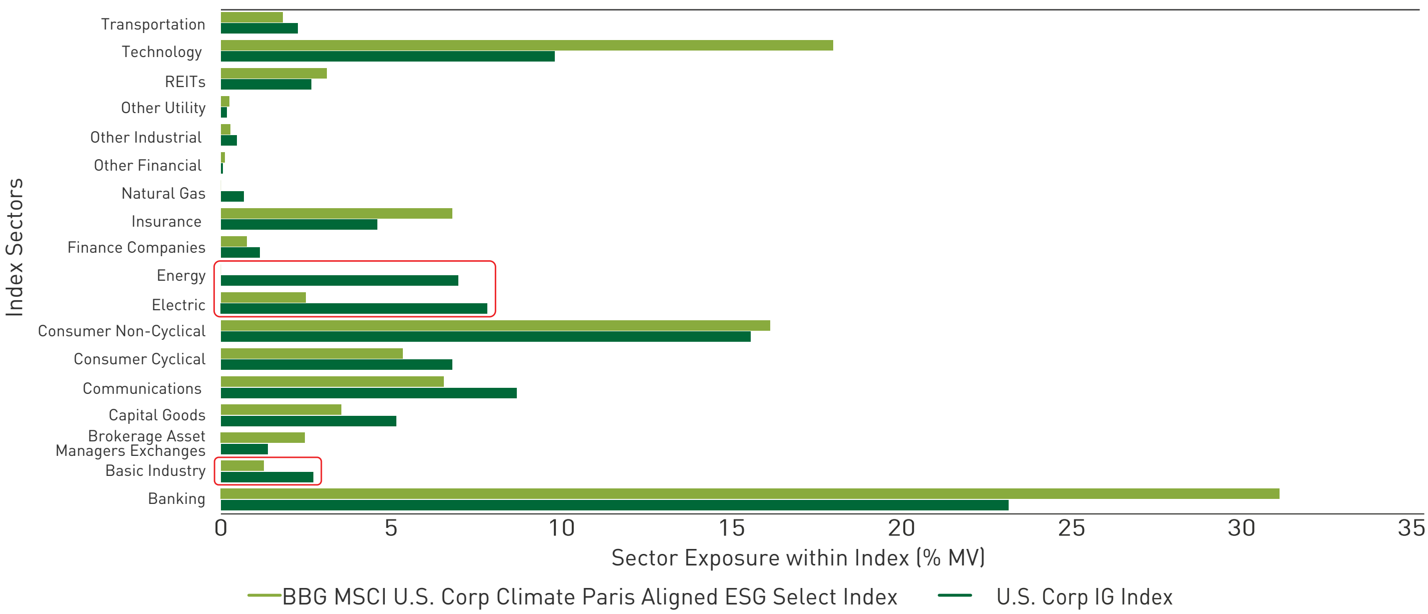
Traditional passive approaches have limitations in a net zero framework

Fossil fuel-free strategies can be passively or actively managed investments that exclude companies that produce, transport, and refine fossil fuels. By excluding such investments from a portfolio, investors effectively exclude themselves from expressing their views on a carbon transition. Debt ownership can enhance an investor's standing to engage with an issuer to encourage real world emissions reductions. A decision to forego that enhanced standing could limit the opportunity to engage. The exclusionary approach restricts access to capital without discretion, effectively penalizing even the best positioned companies that have viable strategies to transition their businesses and are investing in climate solutions.

Passively-managed, indexed net zero investment strategy choices at this time are limited. Based on our research, there are few fixed income indices that offer similar yield and duration characteristics as the Bloomberg (BBG) U.S. Corporate Investment Grade (IG) Index (the "U.S. Corporate IG Index"), which is a common benchmark for investors in U.S. corporate bonds. One of those is the BBG MSCI U.S. Corporate Climate Paris-Aligned ESG Select Index (the "ESG Select").

A passive indexing approach for net zero alignment in fixed income, based on the ESG Select index, takes a largely negative screening approach. For example, the ESG Select index reduces or eliminates allocations to energy and utilities that are present in the U.S. Corporate IG Index (See Figure 1). Constraining exposure to two sectors that are central to pursuing net zero goals poses several investment issues.

FIGURE 1: SECTOR ALLOCATIONS: BBG U.S. CORPORATE IG INDEX AND BBG MSCI CORPORATE CLIMATE PARIS-ALIGNED ESG SELECT INDEX (%)



Source: Bloomberg, as of July 31, 2023.

First, excluding the energy sector from investment theoretically increases the cost of capital for sector constituents by incentivizing asset managers with low tracking error requirements to avoid lending to companies within the sector. In our view, the ESG Select index's reduction or elimination of allocations to the energy and utilities sectors ignores the fact that fossil fuel energy is necessary in many applications at this point in time. A transition to low- or no-carbon operations in these and other sectors will take time, innovation, thoughtful execution, and access to the capital markets to finance the transition. Limited or no access to capital may cause the cost of the transition to increase, and its viability to suffer.

Second, the ESG Select index's limited or lack of exposure to certain sectors relative to the U.S. Corp IG index, could increase idiosyncratic risks for passive investment strategies, as there are simply fewer companies to invest in. In addition, challenges may exist for sourcing longer duration investments; specifically, in the 20-year or longer portion of the yield curve. The utility and energy sectors currently account for 16 percent of total outstanding debt (by market value) in the U.S. Corp IG Index, but they account for a larger 22 percent of the index when looking at the 20-year or longer portion of the index (as of July 31, 2023).

Third, reducing or eliminating exposure to certain economic sectors constrains an investment manager's opportunity to leverage active engagement with company management teams. Similar to the fossil fuel-free strategy, an investor forgoes an opportunity to advocate for an improved climate profile.

What is sometimes referred to as "Active Indexing" approaches include passive indexing with an overlay of some element of active portfolio management. For example, beginning with the reduced opportunity set presented by the ESG Select index, an active indexing net zero approach might increase allocations on a regular basis to companies with GHG emissions-reduction targets or disclosures encouraged by a third-party organization.

In our view, investing in issuers that will contribute to the required GHG emission reductions to reach the 2050 goal demands a more holistic view of risk. A passive indexing strategy generally does not incorporate an analyst's expert judgement, which can take into consideration a more comprehensive view of any given company's credit or net zero profile.

Why an active net zero strategy is different

Breckinridge chose to develop an analytical and actively managed approach to a net zero mandate that is available as a customization to certain investment strategies that we offer. Here's why.

Our analytical and actively managed approach, in our view, combines three key elements that are essential to reaching net zero goals:

- Active, independent research that drives security buy/sell decisions, inclusive of net zero targets that may impact portfolio construction over time,
- Strategic engagement with security issuers, and
- A commitment to methodology transparency and reporting.

We believe a strategy based on proprietary analysis and active portfolio management recognizes the value and importance of credit research in fixed income portfolio construction and management. Independent insights generated by experienced research analysts are essential to identifying what we believe to be the "best actors" in the net zero transition.

When considering a net zero allocation, it is also our belief that a robust analytical approach with active management can be enhanced by the inclusion of environmental, social and governance (ESG) analysis. Awareness is increasing amongst regulators, consumers, investors, and companies of the intensifying effects of a warming planet and its impacts. We view climate change as a material, systemic investment risk that is impacting financial markets today and will likely accelerate in scale over time.

Over the long-term we believe that climate risk will have increased influence in valuation models particularly among the large-emitting sectors. Carbon transition poses risks to carbon-producing assets and creates opportunities in cleaner technologies all of which can influence the outlook for different companies. For many investors, climate change—and the expected government and regulatory responses—is among the most material of ESG risks.

We use our corporate climate transition risk framework to assign company-level net zero alignment categorizations through an ongoing quantitative and qualitative process. We believe that climate transition risk analysis is a natural extension of our research process as it is grounded in financial materiality.

Our approach integrates a strategic engagement effort that is driven by our research team. Engaging with corporate fixed income issuers, organizations and other subject matter experts can provide a robust view of progress on a net zero pathway and prospects for future advancement.

An actively managed strategy allows an investor to advance a transition to a net zero emissions future and, just as importantly, assesses measurable steps on the pathway to that goal.

Conclusions

The net zero transition is accelerating, according to the United Nations, with more governments and corporations making commitments to net zero goals of the Paris Agreement and COP26. Decarbonizing corporate operations will be expensive and will require vast commitments of capital. The capital markets have a vital role in financing the transition to a net zero economy. We believe much of that capital will be raised in the bond market.

Our opinion is that passively indexed investment strategies are not appropriate vehicles for net zero-aligned fixed income investing. These approaches can limit investment manager discretion in sector allocation, security selection and the ability to engage with issuers to advocate for the transition. In effect, investors in these approaches abdicate their role in the net zero transition and ultimately, if index constituents fail to decarbonize, even investors with the most genuine intentions can fall short of their goals using a passive approach.

In our view, directing capital towards issuer companies that are leaders in their sectors from a climate transition risk perspective, regularly measuring progress and consistently engaging with issuer management teams, will drive progress and performance. Actively managed strategies that include a multi-faceted plan to incorporate sector-specific pathways, climate governance, company goals/targets, and measurement of a company's execution against its stated goals and targets are better aligned to offer investors a more comprehensive solution to a net zero-aligned mandate.

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FOOTNOTES:

1. *Asset Owners with $8.5 Trillion Commit to Net Zero Emissions,* United Nations Climate Change, March 10, 2021.
2. Net zero alignment is only one consideration between active and passive investing. Others include fees, costs, and suitability in an investor's overall financial goals. See the disclaimers for more information between passive and active investing.
3. The Bloomberg Barclays U.S. U.S. Corporate Investment Grade (IG) Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility, and financial issuers. Investors are not able to invest directly in any index.
4. Bloomberg MSCI US Corporate PAB Index is designed to meet the standards of the EU Paris Aligned Benchmark (PAB) Label. The index sets an initial 50% reduction of absolute GHG emissions relative to the standard Bloomberg U.S. Aggregate Corporate Index, followed by an annual 7.5% decarbonisation relative to the baseline emissions. The index uses an exclusions-based approach to achieve the decarbonisation trajectory. To be included, securities must be investment grade, fixed-rate, corporate bonds. The index was created on April 8, 2022. The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities. You cannot invest directly in an index.
5. *Asset Owners with $8.5 Trillion Commit to Net Zero Emissions,* United Nations Climate Change, March 10, 2021.
6. The Paris Agreement (French: Accord de Paris), often referred to as the Paris Accords or the Paris Climate Accords, is an international treaty on climate change, adopted in 2015. It covers climate change mitigation, adaptation, and finance. The Agreement was negotiated by 196 parties at the 2015 United Nations Climate Change Conference near Paris, France. The Paris Agreement's long-term temperature goal is to keep the rise in mean global temperature to well below 2°C (3.6°F) above pre-industrial levels, and preferably limit the increase to 1.5°C (2.7°F), recognizing that this would substantially reduce the effects of climate change.
7. The 2021 United Nations Climate Change Conference, more commonly referred to as COP26, was the 26th United Nations Climate Change conference, held at the SEC Centre in Glasgow, Scotland, United Kingdom, from October 31 to November 13, 2021. The conference was the first since the Paris Agreement. The result of COP26 was the Glasgow Climate Pact, the first climate deal to explicitly commit to reducing the use of coal. It included wording that encouraged more urgent greenhouse gas emissions cuts and promised more climate finance for developing countries to adapt to climate impacts.