Doing good or feeling good?

By *Felix Goltz*

Most institutional funds and mandates that claim to have a positive impact on the climate are exposed to large and obvious greenwashing risks. That is the conclusion of recent research we conducted. There is a clear difference between doing good and feeling good.

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It is important to differentiate between two types of greenwashing. The first one is corporate greenwashing, whereby firms advertise environmental credentials for their products and practices that are materially inflated or even contradict their performance. This type of greenwashing receives considerable attention from all stakeholders (think of investors, NGOs and regulators) and is widely criticised.

The second type of greenwashing is portfolio greenwashing by the finance industry. Investment managers may claim that their funds produce a positive impact on the environment when in fact they are not managed in a manner that is consistent with promoting such an impact.

A key feature of popular climate strategies is that they improve portfolio greenness scores, such as weighted average emissions. While portfolio greenness scores are displayed extensively to attract investors, increasing a portfolio's score does not in fact encourage firms to reduce emissions, either through direct impact of allocation on cost of capital or a signalling channel. Instead, three main problems may arise when focusing solely on a portfolio greenness score.

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Displaying greenness by under-weighting is too easy

Climate scores represent at most 12% of the determinants of ESG portfolio stock weights on average. We assess whether climate strategies can correspond to 'closet business-as-usual investing' which, despite displaying higher greenness scores, differs very little from cap-weighted benchmarks. Specifically, we assess what the key determinants of portfolio weights are and how climate scores impact portfolio weights in relation to other characteristics, such as market capitalisation or general ESG scores. As such, we observe that even though investors and managers communicate extensively on the use of climate data to construct their portfolios, these data represent at most 12% of the determinants of portfolio stock weights on average.

It is easy to display greenness by under-weighting high emissions sectors. However, the outputs of these sectors, notably the energy sector, are essential to the functioning of the economy. The key issue is not how to restrict investment in these industries, but how to make sure that these industries invest in technology that allows them to produce needed goods and services with minimum release of greenhouse gases. This alignment requires highly selective intra-sector capital allocation favouring climate change leaders and incentivising progress across and within sectors. We assess whether climate strategies simply underweight such key economic sectors, a choice which would be inconsistent with the promotion of transition. We look at changes in sector allocation over market indices, the contribution of sector weighting decisions to reductions in portfolio climate scores, as well as the weighting decisions of key economic sectors, like electricity, for which the financing of carbon efficiency is key to achieving energy transition for the whole economy.

Green score fails to account for firm dynamics

A portfolio's green score does not account for individual firm dynamics. Firm-level weighting decisions need to send clear signals to firms' management to motivate them to improve their climate performance. There needs to be a synergistic relationship between portfolio construction and engagement. For example, if an investor holds discussions with a company to try and convince it to increase efforts to mitigate emissions, it would be counterproductive for the effectiveness of such an engagement for the investor to increase the weight of the company's stock in the portfolio without relevant strings being attached. To detect how portfolio decisions in climate strategies suffer from blurred signals, we analyse stocks with deteriorating climate scores and report to what extent climate strategies increase the

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weight in such deteriorators. We also analyse the extent to which changes in climate scores influence changes in stock weights in climate strategies.

We checked that our results are robust across different strategy specifications. The issues we identified are general in nature and not specific to a single approach. Since climate strategies do not address such greenwashing risks in their design, it is perhaps not surprising that we detect these issues across many specifications. For example, incorporating emission trajectories and constraints on high climate impact sectors, as required by EU regulation for Paris-Aligned Benchmarks, does not address any of the problems we document. This is clear from analysing the constraints imposed by the regulation and thus, unsurprisingly, shows in strategies that we adjust to respect such constraints.

Recommendations

Our recommendation for climate conscious investors is to stay vigilant when they see portfolio-level improvement in climate metrics and to look beyond cosmetic improvements. They should seek to have an impact on corporate behaviour through the synergistic action of engagement efforts combined with consistent capital allocation decisions. The danger is that they pay for 'feel good' products that could in fact induce complacency and delay meaningful action in the face of the urgency of addressing climate change. Impact consistency involves making sure that firms with deteriorating carbon performance are not rewarded, that key industries remain properly represented and funded, and that climate considerations are a meaningful driver of capital allocation.

The objective of our research was not to stigmatise any commercial offerings. The real problem is not an intention to do harm, or even a lack of attention to the climate question, but the negative consequences of applying a portfolio construction method that mixes up financial and climate data on the potential impact of climate investment strategies. By wanting to reconcile ambitious carbon intensity reduction objectives with tracking error constraints and/or compliance with cap-weighting hierarchies, the traditional green portfolio construction approach fails to offer strategies that are consistent with the desire to achieve climate engagement from investors.

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In this context, and beyond recommending individual due diligence, we think that it is time for a paradigm shift in climate investing. It is not possible to achieve a climate revolution by continuing to stick to traditional benchmarks. It is only by freeing climate investment from tracking error minimisation constraints and objectives that we can hope to have benchmarks that are consistent with climate alignment objectives.

To succeed in this change, which is essential to effectively mobilise the financial industry for clients, the regulator should draw up clear rules for the fight against portfolio greenwashing. It should avoid promoting green labels based on regulations that in no way protect investors against greenwashing risks, as is the case with the likes of the EU Paris-Aligned Benchmark regulation.

As part of this consideration, and to bolster the fight against portfolio greenwashing, we suggest that when climate considerations represent less than 50% of the determinants of the weight of the stocks in the portfolio that is presented as representing an alignment strategy, then the portfolio should be considered to be subject to a significant risk of greenwashing and it should not be possible to consider or label it as climate-friendly or aligned. ■

SUMMARY

Even though investors and managers communicate extensively on the use of climate data to construct their portfolios, these data represent at most 12% of the determinants of portfolio stock weights on average.

The lack of consistency between the evolution of companies' climate performance and their weights in green portfolios has negative consequences for the impact of investor engagement on these same companies.

It is only by freeing climate investment from tracking error minimisation constraints and objectives that we can hope to have benchmarks that are consistent with climate alignment objectives.