Feasible passive investment solutions to address climate change challenges

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A lot of action is needed to fight the negative consequences of climate change, and both the financial industry and investors can help combat this crisis. To create a climate-smart economy, a vast amount of capital is required: Policy is calling for annual investment of USD 3.8 trillion by 2050[70], which would potentially generate USD 26 trillion in business opportunities[71].

While the global transition to a low-carbon future is a must, investors are looking for solutions that can both meet their financial objectives and contribute to a low-carbon economy. Passive investments tracking an index play a big role here, as they are widespread among institutional investors with substantial amounts of assets. A common solution is investing in funds tracking indices that exclude fossil fuels. While this might initially look like an easy and obvious choice, there are consequences. For instance, by excluding "oil majors", investors will miss opportunities, as some of these companies are among the largest investors in renewable energies or likely to provide technological solutions, such as carbon sequestration.

Engagement instead of exclusion

While considering the needs of passive investors, such as staying close to a benchmark and keeping costs low, UBS Asset Management's rules-based strategy for climate-aware investments is different. It maintains allocations to carbon-emitting companies with the two goals of supporting positive change through proactive engagement with companies that appear to be the least well positioned, while also supporting companies that are developing new, lower carbon technologies.

Depending on their business models, companies are subject to different risks related to climate change. In our investment process, we assess five major risk categories:

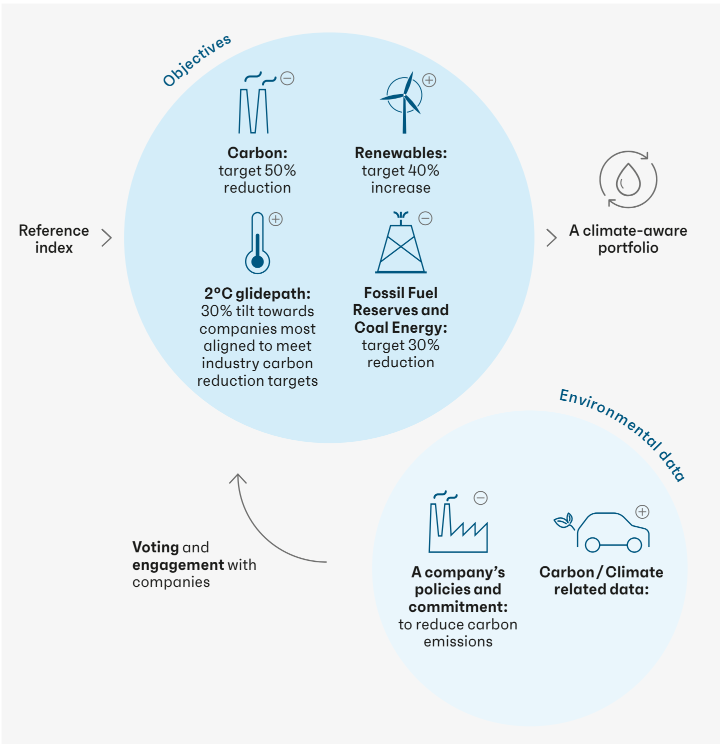
— **Regulation risks:** for example the effect on costs of carbon pricing on large GHG emitting companies
— **Market risks:** such as the move away from products with high carb on- and energy-intensity
— **Technology risks:** such as the large scale substitution of products and services
— **Physical risks:** such as the risk to fixed assets and/or supply chains
— **Reputational risks:** such as the stigmatization of an industry

In the equity space, our climate approach applies tilts to an equity benchmark away from companies we believe are less likely to be in line with the low-carbon economy – and towards companies we expect to meet industry carbon reduction targets (see exhibit). By analyzing how companies are positioned for the transition to a low-carbon economy, the strategy seeks to reap the benefits of that shift. Recently, we have also implemented the strategy to a global corporate bond benchmark.

The portfolio targets:
— At least 40% higher exposure to companies that generate renewable energy and supporting technology compared to the parent index
— A 30% tilt towards companies most aligned to meet industry carbon reduction targets in line with the beyond 2°C scenario
— 50% reduction in carbon intensity scope 1. We also aim for reductions at scope 2 and 3.

At UBS AM we see a clear investor appetite for directing capital in climate solutions. We believe that continuous development of offerings and active client engagement is crucial to investor success in an increasingly carbon-constrained world.

Portfolio construction process
Source: For illustrative purposes only. UBS Asset Management, June 2021.



70 Source: https://www.climatepolicyinitiative.org/publication/global-landscape-of-renewable-energy-finance-2020/
71 Source: https://www.wri.org/blog-series/the-26-trillion-opportunity