TargetNetZero Equity

As carbon-intensive sectors retreat, what opportunities lie ahead ?

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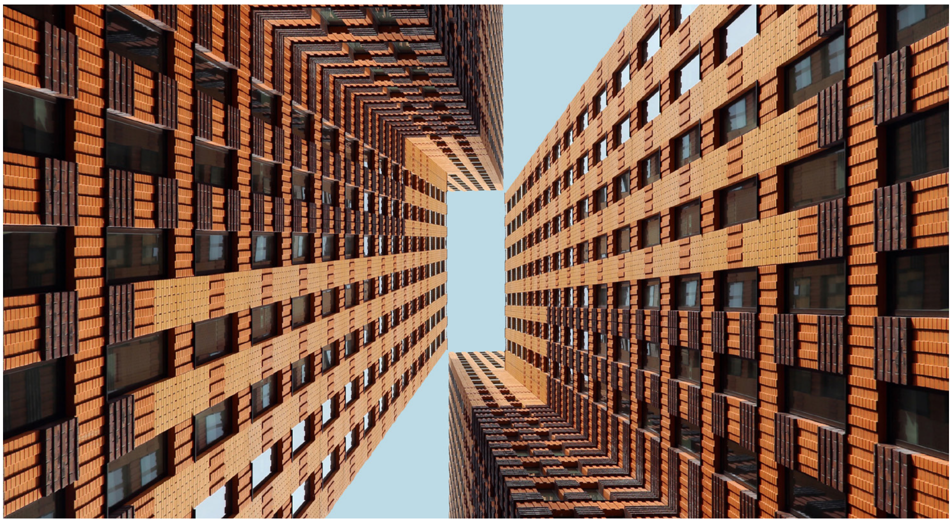

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With the energy shock subsiding and the climate transition back in focus, what potential equity upside might companies aligning to net zero offer investors? Forecasting how a carbon-constrained economy would impact businesses' growth, earnings and valuations, we gain insights into how firms that are genuinely decarbonising could benefit performance.

Need to know

- Our risk controls helped offset a tough period for decarbonisation-focused equity strategies. But as the performance of fossil-fuel companies declines with traditional energy prices, we look forward to stock-selection prospects among decarbonising companies
- Assertive climate policies and rising carbon prices should lead to the market demanding higher risk premia for climate laggards relative to leaders, in our view, which should favour decarbonising firms
- Our analysis of equity opportunities in a carbon-constrained scenario shows that decarbonising firms could offer significant upside to our TargetNetZero global and European strategies relative to their benchmarks

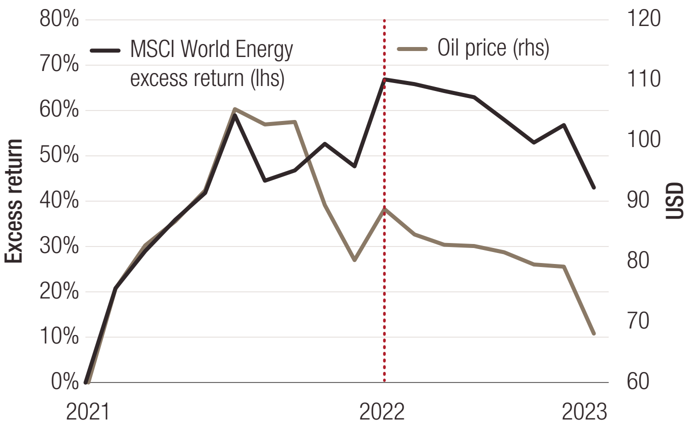
Back on track: the climate transition

Last year saw a setback in mitigating climate change: war in Ukraine and soaring inflation lessened the pressure to reduce emissions as countries prioritised energy security. Some nations pivoted back to coal while others extended the lives of nuclear power plants. The significant increase in non-renewable energy prices benefitted fossil-fuel producers, challenging climate-driven strategies. Despite this headwind, tight risk controls on sector exposures supported our TargetNetZero equity strategies.[1]

But in 2023, the climate transition has come back into focus, with energy prices cooling down and the simultaneous decline in the performance of energy stocks (figure 1). The European Union (EU) Green Deal Industrial Plan, which followed the US Inflation Reduction Act, is a one of the policy catalysts helping to accelerate the net-zero transition. It includes relaxing state-aid rules and simplifying the regulatory environment for low-carbon technologies, making access to funding quicker and easier, as well as introducing policies to support the creation of an open and resilient cross-border supply chain for critical raw materials.

Moreover, in October the EU is set to launch a carbon border tax to support transitioning firms. Under the Carbon Border Adjustment Mechanism, countries exporting products into the bloc will have to cover the cost of their carbon emissions, thereby meeting the same environmental standards as domestic firms. The policy will first apply to the most pollutive industries – including iron, steel, cement, fertiliser, electricity production and hydrogen – before encompassing other goods.

FIG 1: CARBON-INTENSIVE SECTORS ARE IN RETREAT AS ENERGY PRICES COOL DOWN



Source: Bloomberg at June 2023. For illustrative purposes only. Past performance is not a guarantee of future results.

Our TargetNetZero equity strategies have benefited from the favourable landscape this year, especially in Europe.[1] Sector allocation has supported returns, due to our underweight to carbon-intensive industries. However, this part of our investment process is not expected to deliver significant upside due to tight risk controls. The full performance potential of the TargetNetZero strategies lies in stock selection.

To gain an insight into the potential opportunities lying ahead, we undertook a quantitative analysis assuming a carbon-constrained scenario for the global economy, which we describe in the next section of this commentary. This is a simplified approach, but it nevertheless indicates the potential magnitude of the financial impact of investing in decarbonising companies. In a nutshell, the results suggest that our TargetNetZero equity portfolios could benefit from an estimated 6% upside relative to their benchmarks after the climate transition is priced in by the market.[2] Given the portfolios have tracking errors that are well below 1%,[3] this potential excess return is significant.

Valuations, earnings, growth – three ways high-emission companies could be impacted

To evaluate how well our TargetNetZero portfolios are aligned to the climate transition, we use metrics such as carbon footprint and temperature alignment. While they provide valuable insights into how well our strategies are exposed to transitioning companies relative to other portfolios, they say little about opportunities for generating returns.

At its core, the TargetNetZero strategy focuses on carbon-intensive companies that are implementing credible emission-reduction plans. We see several channels through which the relative valuations of high-emitting companies will potentially be impacted by the climate transition:

1. **The impact on stock risk premia or required rates of return.** As the market starts pricing in climate-related risks, we expect the valuations of climate-transition laggards to be progressively discounted relative to leaders
2. **The impact on earnings**. Companies that fail to reduce their carbon footprint will face higher costs due to increasing carbon prices in the form of taxes or offsets. The magnitude will depend on the path of carbon prices and how companies respond, which includes their ability to pass the costs on to consumers
3. **Constraining growth.** This is probably the option of last resort for a company aiming to reduce its absolute emissions, as it involves shrinking its business. Firms unable to transition while their activities become curtailed by emission budgets will be forced into this channel. While this is not the most likely scenario, especially for low-carbon companies, it requires few additional assumptions to arrive at a quantitative result

[1] Past performance is not a guarantee of future results.
For detailed performance information and commentary on our Target NetZero equity strategies, please visit:
- TargetNetZero Equity Europe
- TargetNetZero Equity Global

[2] Important information on target performance/risk: target performance is an estimate of future performance based on current market conditions and are not an exact indicator. What you will get will vary depending on how the market performs and how long you keep the product.

[3] Source: LOIM at May 2023.

Forecasting a carbon-constrained world

Our analysis focuses on the third channel: a climate-transition scenario where companies will be forced to reduce emissions by constraining their long-term growth. We consider a relatively mild, 'market-neutral' version in which the average impact on growth rates across the investment universe is zero. That is, the transition will result in a redistribution of market share between climate leaders and laggards while not causing a global slowdown.

For each company in the investment universe, we compare its forecasted emissions until 2050 to its emissions budget[4] and compute the implied growth rate required to equalise the two. Naturally, companies exceeding their emission budgets will incur a negative impact on their growth rates since they will need to scale-down their activities to reduce their carbon footprints. In contrast, companies that are undershooting their emission budgets will benefit from higher growth rates, as they expand and gain market share as climate laggards contract. For constituents of the MSCI World index, market neutrality is achieved through emission budgets aligned with global warming of 2.7 °C by 2050.

Measuring the financial impact

In our analysis, we estimate the impact of the change in the growth rate on stock valuations by using the following formula:[5]

$$\frac{\Delta P/P}{\Delta g} = \frac{P/B - 1}{P/B \times D/P}$$

where $\Delta P/P$ is the percentage change in stock price, Δg is the change in growth rate, P/B is the price-to-book ratio and D/P is the dividend yield.

Naturally, the formula suggests that value stocks (with low price-to-book ratios and high dividend yields) are less sensitive to variations in the growth rate. Where When the company's value is as low as its book value $(P/B = 1)$, the return on equity is equal to the required rate of return, meaning the investment will generate no excess return. As a result, the stock valuation is not sensitive to how fast the company is growing.

To evaluate potential opportunities for our TargetNetZero strategies, we first compute the stock-return sensitivities for the global and European company universes[6] using the formula above, using median price-to-book and dividend-yield ratios (table 1).

For example, an increase of 1 percentage point in the long-term growth rate of a company in the global universe will have a 15% impact on its valuation.

Using the estimates of companies' growth impacts from the previous section and the active weights of our portfolios at the end of May 2023, we compute the net growth impact of the climate-transition scenario. The results show that overweighted companies in our global portfolio will benefit from 2% growth in excess of underweighted companies. The financial impact is computed by multiplying the degree of sensitivity by the impact on growth and by the portfolio's active share.

TABLE 1: COMPUTING FINANCIAL IMPACTS ON TARGETNETZERO EQUITY PORTFOLIOS

Name	Sensitivity	Growth impact	Active share	Financial impact
Global	15.1	2.0%	21%	6.1%
Europe	14.2	2.3%	18%	5.7%

Source: LOIM, Worldscope at May 2023.
Financial impact = sensitivity × growth impact × active share.

Only part of the story

In this analysis, we postulate a simple scenario in which the most progressive decarbonising companies in climate transition will benefit from excess growth while laggards will have to downsize. Our findings rely on our ability to correctly measure the decarbonisation trajectories of companies, which is an optimistic assumption but reflects the active approach we take. On the other hand, we consider only one of three identified channels through which stock valuations will be impacted.

Going forward, given the direction of policies and carbon prices, we expect the market will demand higher risk premia for the climate laggards relative to leaders. In our view, this should provide an additional boost to the TargetNetZero strategies – which we have documented in a previous paper.

For more information about our TargetNetZero equity strategies, please click here

[4] Emission budgets for companies depend on the global warming scenario in question.

[5] Assuming a constant dividend growth (Gordon model), stock price $P = \frac{D}{r-g} = \frac{B \cdot (ROE-g)}{r-g}$, where r is the required rate of return, D is the next period dividend yield, and ROE is the return on equity. The formula in the text follows by differentiating this expression with respect to growth rate, g.

[6] Stocks that are part of MSCI World Index and MSCI Europe respectively.

IMPORTANT INFORMATION