

# Investing to achieve real-world emissions reduction

Transitioning from fossil fuels to renewable energy is a complex challenge. Despite record renewable installations in 2023, achieving real-world emissions reductions demands nuanced approaches and active investor engagement.

By Sarah Peasey

## The decarbonization dislocation

Transitioning away from fossil fuels to renewable, reliable and economical sources of energy was never going to be easy. The last two years made the challenge even harder, with a major war in Europe sparking fears of energy security, growing geopolitical ten-



sions, tighter monetary policy, stubborn inflation, and disrupted global supply chains. This has all made navigating decarbonization a greater challenge for investors.

We had a record year for renewable energy installations in 2023, with capacity additions increasing by

almost 50% year-on-year. Overall, however, while government policy initiatives around the world have offered much hope, implementation has been bumpy, widening the gap between investor net-zero commitments and 2030 country emissions intensity goals. Some investor targets call for a rate of portfolio emis-

**FIGURE 1: CLIMATE INDICES CAN EXHIBIT UNWANTED SECTOR AND STYLE TILTS VERSUS PARENT BENCHMARKS**

	MSCI World Index	MSCI World Climate Change Index (CTB)	MSCI World Climate Paris Aligned Index (PAB)
Sector Weights	Information Technology	21.7%	26.5%
	Financials	15.0%	17.1%
	Health Care	12.8%	14.5%
	Consumer Discretionary	10.9%	9.7%
	Industrials	10.8%	12.7%
	Communication Services	7.3%	6.6%
	Consumer Staples	7.2%	2.6%
	Energy	5.2%	0.0%
	Materials	4.1%	2.2%
	Utilities	2.6%	2.9%
	Real Estate	2.3%	5.3%
Valuation Metrics	P/E	19.45	22.70
	P/B	2.89	3.30

Source: MSCI, as at 29 September 2023.

## ‘Every company is on a different journey to net zero and requires targeted engagement to pinpoint specific areas of weakness and support continuous improvement.’

sions intensity reduction more than twice as fast as that implied by national targets. Moreover, 2024 is set to be a year defined by politics, with election results likely to raise uncertainty and prove consequential for the pace and success of the energy transition.

We believe this decarbonization dislocation will bring into question whether investors can achieve real-world emissions reduction outcomes.

### The limitations of passive investing

As investors grapple to find a simple solution to align their portfolios with the transition to net zero, there has been a rise in demand for passive indices and products based on the Paris Aligned Benchmarks (PAB) and Climate Transition Benchmarks (CTB), whose carbon emissions are aligned with the objectives of the Paris Agreement.

Both PAB and CTB indices are primarily constructed using traditional measures such as carbon footprint and carbon intensity, which are useful because they are comparable across companies and portfolios, but have major pitfalls, in our view, for investors who rely heavily on them for assessing net-zero alignment.

Scope 1 and 2 carbon emissions are often unreported or published with a lag, and these issues are even more severe for Scope 3 reporting. Therefore, adjusting the weighting of individual securities in the investment universe based on reported carbon emissions alone does not ensure the reallocation of capital toward climate-friendly investments. Lagging and backward-looking emissions data also cannot account for individual issuers’ plans to reduce future emissions. As such, we do not believe relying on simple reported emissions can ensure investors achieve their ultimate net-zero objectives.

Additionally, rule-based approaches cannot apply any nuance or context to adjust these often volatile emissions data. This can lead to artificially high index turnover to match the required 7% annual carbon intensity reductions, which can in turn create greater tracking risk. For example, as of 29 September 2023, several PAB/CTB-aligned MSCI indices we analyzed had a 12-month turnover in the range of 10%-19%, while the MSCI World Index turnover was 2.2% over the same period.

This sub-optimal portfolio construction is exacerbated

by the exclusionary criteria imposed. In our view, excluding companies with relatively large carbon emission profiles, regardless of their climate plans, could starve entire industries, like the energy sector, of capital needed to introduce more renewables, build carbon-capture infrastructure or make operations more carbon-efficient.

We also believe exclusions can impair returns and introduce unintended style bets, especially a growth tilt away from carbon-heavy sectors (Energy and Materials) and toward carbon-light sectors (Information Technology), as seen in Figure 1. Exclusions also diminish investors’ ability to engage these carbon-intensive companies and effect change.

We believe every company is on a different journey to net zero and requires targeted engagement to pinpoint specific areas of weakness and support continuous improvement. When it comes to achieving real-world emissions reductions, we advocate for a more active investment approach that includes setting a tracking-error-risk budget, applying forward-looking climate-transition risk assessments, and engaging with companies. ■

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## SUMMARY

The gap between investors’ net-zero commitments and countries’ 2030 emissions intensity targets has widened in recent years.

Slippage against 2030 country emissions intensity goals brings into question investors’ ability to achieve their own real-world emissions reduction targets.

PAB and CTB indices have major pitfalls for investors who rely heavily on them for assessing net-zero alignment.

An active investment approach that incorporates forward-looking climate transition risk assessments and engagements with companies can help to achieve real-world emissions reductions.