Sustainability Podcast

“From Targets to Tactics: How We’re Scoring the Energy Transition”

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Bentley Kaplan

Hello and welcome to the weekly edition of Sustainability Now, the show that explores how the environment, our society and corporate governance effects and are affected by our economy. I'm Bentley Kaplan, your host for this episode. And on today's show, we're going to take a look at the risks and opportunities as companies and whole markets start to lower their emissions, something that you'll hear referred to as the energy transition or perhaps the low-carbon transition. Think of this transition as a kind of long in-between, the years and even decades between the early 2020s and a lower emission future. It's a long in-between that is tricky and full of caveats, because practically figuring out investment risks and opportunities, especially across a whole portfolio of investments is hard.

Gladly, my two guests are very much up for the challenge, and we'll be tackling this in two parts. In part one, we'll take a high level view of our energy transition framework and we'll look at why it can be so vexing to measure risk and opportunity for companies that are in a low-carbon transition. And then in part two, we'll dive much deeper into a very specific part of our energy transition framework into something we call materiality-weighted emissions. Apart from giving you a new term to flaunt in front of impressed colleagues, it'll really help to highlight why context is going to be such a big part of navigating the years ahead. Thanks for sticking around. Let's do this.

Okay, so part one of this episode starts a few years back, around 2020 and 2021. It was a heady period for corporate net-zero targets, the idea that companies were aiming to release net-zero emissions within a specific timeframe and overwhelmingly by 2050. There was a lot of optimism and a decent number of rose-tinted glasses being handed around. It's fair to say that since then some of that fanfare has died down. But the fundamental arguments in favor of a low-carbon future, including the economic case for renewable energy and mitigating the effects of climate change very much remain.

But when that low-carbon future would arrive and what will happen between then and now, well, that's where things get trickier. Individual companies may experience very different environments. Some may be presented with strong incentives to decarbonize, others may see big technology gaps between their current activities and feasible low-carbon alternatives.

For some, a quick transition means a competitive advantage. For others, doing so may put their whole business at risk. And for investors looking across a portfolio of different businesses in different regions, the upshot of an energy transition in practical terms, well, there's a lot of tangled thread to try and lay straight. But Chris Cote out of MSCI's Boston office has been hard at work with some of my best and brightest colleagues to lay that thread nice and straight. And this work and research has all been building towards an energy transition assessment, one that can help investors better understand at a company level the risks and opportunities of a low-carbon transition.

Chris Cote

The idea is to understand the risks that companies face because of this transition. Where do those risks come from? What's driving them? How are they changing over time? And then how companies are adapting, preparing for dealing with this change. The energy transition is moving along, but maybe in fits and starts. Some countries and regions are rolling back policies, some are moving them more aggressively forward, accelerating the transition. If you look around the world, there are new carbon pricing mechanisms coming in. Vietnam just announcing an increase to theirs. China is continuing to up the ante across the board. The Philippines is discussing this. I mean, you look and you'll find it in different countries around the world, even where in other large important instances there is also considerable rollback. And I think this unevenness in the transition creates opportunities, creates risks, but the divergence is something that should cause you to pay attention and say, how do I understand this more deeply?

I've started talking about regulation, but it's not just about regulation. Businesses are adopting new technologies that can help them make products more efficient. So keeping up with these technologies, what's available, what's in the pipeline, what's more commercially adoptable today versus what might be more useful in the next five to 10 years? And we've spent a lot of time within our research team separating out what's ready to roll today to decarbonize a cement factory, reduce the emissions from aluminum, get that airplane flying more cleanly versus what's a moonshot and we're probably not going to see it in the next five to 10 years or maybe ever.

And finally, this does come back, of course, to the emissions that firms are producing, but we want to understand whether those emissions are creating risks. And we do that by understanding whether those risks manifest through technologies and or policies, right? But it's only through these other vectors that the emissions really matter for the business fundamentals of companies at the end of the day.

Bentley Kaplan

Right. So as Chris says, there are a number of different factors that create more or less transition risk for a company, essentially the level of pressure they're under from regulations or technology. But the team has also looked at the flip side of pressure, how prepared companies are to respond to transition their businesses or products to lower emission versions. And they did this by looking at things like how corporate strategy includes climate risk, a company's emissions track record, the quality of their emission reduction targets, and how they've stuck to their promises in the past, and also what types

of opportunities they have access to because of the energy transition. For companies that face greater pressure, this transition readiness matters much more than for companies that aren't in the hot seat.
And so with this assessment framework in mind, I asked Chris about its use case for investors, investors that are already looking at different types of climate data, including company emissions or their alignment with specific climate goals. And to answer that, Chris outlined the different sets of objectives that investors might have hopefully arranged into buckets.

Chris Cote

One bucket, which is separate from the others, it's just about aligning with regulation. You need to comply with the disclosure requirements from the EU or other places. Beyond that, getting back more to the investment objectives is about managing risk and return, the 101s of managing a pool of assets.

But then the next question becomes over what time horizon are you looking to do this? And this is where we began to see some interesting divergence. If you're focused more on next quarter or next year, you need one set of tools. If you're looking out over the next five to seven years, you want to incorporate a different type of information. And that may differ again from if you're looking out over the next 10 to 20 years and you feel confident riding out the waves that may come with the market over these shorter time horizons.

To marry this back to the transition-focused objectives that our clients have, they're asking, do we try to manage this systemic risk versus managing what's in their portfolio today? There are key differences of whether you're trying to reduce all of the emissions of all of the economy compared to saying, I'm only looking at the companies in my portfolio and I want to understand what's going to happen to their bottom lines because of climate change, because of the transition in the next few years.

We focused on that second case. We have tools already, both MSCI and with the industry more broadly to focus on whether companies and portfolios are aligned with the goals of the Paris Agreement, the science that comes out of the intergovernmental panel on climate change, for example, is my portfolio aligned with a 1.5 degree or a two degree or a three degree world, or am I protecting my portfolio from the risks of transition and seeking opportunities where we can get them? This is becoming an increasingly important question, and we've heard that investors need more tools in their toolkit to be able to answer it.

Bentley Kaplan

Okay, that was our official intermission music. I hope you enjoyed it. In part one of this episode, Chris helpfully set the stage by walking us through a new approach to measuring transition risk for companies. Now, for part two, we're going to dive into a very specific part of our new energy transition framework. It's a part that I find particularly interesting, one that really gets to the heart of why transition risk is all about context. Together with Chris and a formidable team, my colleague, Guido Giese, has been working on the concept of materiality-weighted emissions, the idea that not all emissions pose an equal risk to all companies. I persuaded Guido to give us a rundown of this research and a user-friendly explanation of just what the heck materiality-weighted emissions are.

Guido Giese

So historically, investors have been looking at the total carbon footprint of the portfolio for two different reasons. They looked at the total footprint as a measure for the impact on the world, so how much the companies in the portfolio are polluting the world. And they looked at the total carbon footprint as a measure for transition risk, meaning companies that have a high carbon footprint have a lot of transition risk.

Now we've come to realize that this is not really true because historically, carbon emissions were risk-free. Companies could pollute as much as they wanted. That has changed. I mean, some carbon emissions are under pressure, under business pressure, so not all emissions are risk-free. But on the other hand, it's also not true that all emissions face the same level of risk. It makes a big difference whether you emit a ton of emissions in Europe or a ton of emissions in emerging markets.

And also it makes a difference whether you look at the ton of Scope 3 in downstream emissions or Scope 3 in upstream emissions or Scope 1 emissions. So the idea of the materiality-weighted footprint was really to start differentiating between tons of emissions that have a lot of risk exposure versus tons of emissions that don't expose you to that much of risk because it is what it is. I mean, we know that Europe has more exposure to climate risk than emerging markets. That needs to be reflected in the so-called materiality-weighted carbon Footprint. So we created a concept for that as a sub-component of the new energy transition framework that helps investors to identify what are the material tons of emissions in your portfolio that really expose you to risk in the near term.

Bentley Kaplan

Okay, so not all emissions are created equal, or more accurately, not all emissions present companies with the same level of risk, but Guido is all about the, so-what? Theory is great, but is it a useful explainer of what we see out in the world? So what his team said about doing was looking at whether materiality-weighted emissions tell a clearer story of financial performance than a more traditional company carbon intensity, that is emissions relative to something like revenue.

And a quick heads up, Guido's going to talk about ACWI, which is the MSCI ACWI Index, a global sample of around two and a half thousand mid and large cap companies. And he's also going to talk about the Barra Factor model, which is a very nifty tool that helps investors to identify the factors that driver a stock's performance. You are welcome. And without further ado, here's Guido again.

Guido Giese

So we compared the traditional carbon intensity of a portfolio. So we take all the emissions Scope 1, 2, 3, add it up as an intensity to the materiality-weighted carbon intensity. So we compare the performance characteristics in ACWI and ACWI sub-regions in terms of earnings performance and stock performance. And so we used Barra Factor model to do that because Barra Factor model allows us to test the performance characteristics of carbon intensity while controlling for all traditional factors like industry, region, currency, and all the style factors. And we found that if you use traditional, the full carbon intensity, results aren't clear. Depending which region timeframe you look at, sometimes the carbon intense companies outperform, sometimes they underperform. It's not a very clear picture. But when you use the materiality-weighted carbon intensity, it's a much clearer picture that the carbon efficient companies have performed better and fairly consistently across regions than they're more carbon intense peers. So it's a much clearer picture of performance difference. And the difference was even clearer looking at the earnings.

So when we look at the traditional carbon intensity, we look at is there an earnings differential or earnings growth differential between carbon intense and less intense companies? Very noisy data, not clear trend. When we looked at the same questions through the lens of materiality-weighted carbon intensity, much clearer picture that companies that were less carbon intense in each sector had a better earnings performance than their carbon intense sector peers. So on earnings and stock performance, we did see that the materiality-weighted carbon footprint gave us a much clearer risk and performance signal.

Bentley Kaplan

Okay, so let's take that in a little more slowly. Guido and team looked at two different ways of measuring the carbon efficiency of companies. One was more traditional, taking total emissions over revenue, whereas the other only considered material emissions or so-called materiality-weighted emissions. And in both cases, the team looked at performance differences between the most and the least carbon efficient companies.

And what they found was that when they used the second option, materiality-weighted emissions, carbon efficient companies showed a clearer outperformance on average than carbon inefficient companies. In other words, companies that were really good at managing emissions that pose higher risks tended to perform better than companies that did not have a handle on these riskier emissions. And this difference was less pronounced when the team used total emissions without considering the risk that those emissions posed to companies. And that's definitely an intriguing outcome, one that raises a few questions, particularly around whether the market might be mispricing carbon emissions.

Guido Giese

Yeah, I think that's the important one because we reached a very interesting conclusion here because there is so much discussion in the market, academia and practitioners. Is the market mispricing carbon emissions? Because there are research papers saying, oh, there's a bit of positive performance, a bit of negative performance, inconsistent, contradictory, and maybe it's mispricing. And I think our conclusion is different. We came to the conclusion maybe the market has been smarter than we thought because the market has actually priced the difference between material carbon emissions and not so material emissions. Why can the market be so smart? Well, because you can tell the difference based on public information. I mean, we know that the EU has a carbon tax other countries. I mean, why would the market not use that? It's public information.

So I think some of the researchers might have underestimated the differentiation that the market is able to see in terms of when pricing carbon emissions. So we think that the difference between materiality-weighted carbon footprint and the full carbon footprint in terms of the pricing behavior in our factor models shows us the market is pricing it, and it does differentiate between high risk and low risk emissions.

Bentley Kaplan

All right. So the transition is complicated. For companies, there are different sources of pressure to consider, and depending on what type of business you're in and where you're operating, the intensity of that pressure is going to vary. For some, having a strategy to transition and a good track record on cutting emissions, setting clear targets, and if you're lucky, having access to transition-related opportunities really matters.

But that's not true of all companies. Some will have a much longer lead-in with much less pressure to transition in the near term. The research that Guido described shows that emissions at face value aren't telling the whole story. Some emissions may present much higher risk than others. And at companies that were on top of these riskier emissions tended to outperform companies that weren't.

You see, it turns out that boldly announcing net-zero by 2050 and waving away the long in-between doesn't quite work. And it's a complicated caveated in-between that investors will be working their way through. Whether their time horizons are short, medium, or long-term detail is really going to matter. And quite happily, for my MSCI colleagues, getting into that detail to draw out clear signals and actionable insights is what gets them up in the morning.

And that is it for the week. A massive thanks to Chris and Guido for their take on the news with a sustainability twist. A reminder to keep an eye on msci.com for all of our upcoming research. Also, Chris, Guido, and some of my other excellent colleagues are out and about trotting the globe and sharing much more on the energy transition score. So if you love an MSCI event, well, see if you can't snag a seat to hear them in person.

And last but not least, I also do want to say thank you very much for tuning in. You know the score. If you like what we're doing, then let us know. Drop us a review, rate the show on your platform of choice and tell a friend or a colleague about this episode. Thanks again, and until next time, take care of yourself and those around you.

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