Q&A

Russell Investments' approach to managing reduced-carbon portfolios

Scott Bennett

With: Scott Bennett, Director, Equity Strategy and Research

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Q: SCOTT, INTEREST IN REDUCED-CARBON PORTFOLIOS HAS INCREASED GREATLY IN RECENT YEARS. WHAT DO YOU SEE AS HAVING BEEN THE KEY DEVELOPMENTS IN THIS SURGE?

A: It's certainly a growing area of interest. Russell Investments first started managing reduced-carbon portfolios back in 2015. Since then, we've seen interest expand in pretty much every part of the world. And as it's grown, this area of portfolio management has also evolved. There's more information available as approaches are becoming much more sophisticated. That's why we've recently made significant changes to how we manage these portfolios.

Q: WHAT LIES BEHIND THESE CHANGES?

A: Well, the basic approaches remain common—such as reducing our exposure to companies with high fossil fuel reserves or simply aiming for a lower carbon footprint than a standard benchmark. But sometimes those approaches aren't as effective as they should be. For example, they can lead to a reduced exposure to renewable energy. That's because some companies currently involved in energy production are among the best positioned to invest in renewable energy programmes—and they're strongly incentivised to do so. But standard decarbonisation might underweight these companies. And that could lead to a renewable energy mix worse than that of the benchmark. And along the same lines, we've found that the naïve approach can sometimes lead to worse overall environmental, social and governance scores—ESG scores. So, we wanted to find ways to address that, too.

Q: HOW ARE THESE ISSUES ADDRESSED UNDER THE NEW APPROACH?

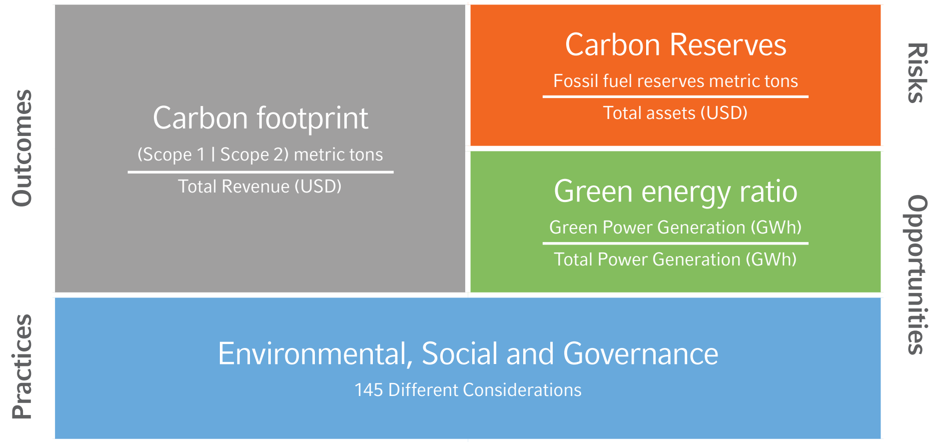
A: We think about our efforts in three categories. First, we've added a Green Energy Score to increase the focus on renewables. Second, we've introduced an explicit exclusion for predominately coal based companies, because coal is the least efficient fossil fuel in terms of CO_2 emissions for each BTU[1] generated. Coal accounts for 44% of global CO_2 emissions, but only supplies 30% of energy use.[2] Not good. And, third, we've explicitly built broader ESG[3] scores beyond carbon footprint. And we've built these scores into the portfolio construction process. The goal is to create better alignment with sustainability goals beyond just carbon emission reductions.

[1] British Thermal Unit

[2] Steinbarth, E. & Bennett, S. (2017). "Decarbonisation 2.0: Russell Investments' sustainable investing solution for the energy transition". *Russell Investments*.

[3] ESG information utilised is sourced from Sustainalytics

Exhibit 1: Sustainability Considerations



By supplementing the direct carbon reduction with broader ESG ratings, we believe we've created a more robust measure of sustainability.

Q: HOW DO SECTOR AND INDUSTRY EXPOSURES FIT INTO REDUCED-CARBON PORTFOLIO CONSTRUCTION?

A: Well, that's a big area of risk focus. Typically, a handful of companies are responsible for the vast majority of a portfolio's carbon footprint. It's like the 80/20 rule. At the end of 2016 (31 December 2016), 20 percent of companies are responsible for 86 percent of the aggregate carbon footprint in the MSCI World universe. And that skewed ratio can get bigger when grouped by sector. With that in mind, we seek to control for the size of active bets. If we were to just divest from the largest emitters, that could lead to large sector, industry and country bets relative to the benchmark.

Q: YOU MENTIONED SUSTAINABILITY GOALS BEYOND CARBON. TELL US ABOUT THOSE.

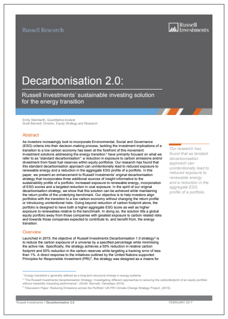
A: ESG ratings give us another measure. They tell us how well issuers proactively manage the environmental, social and governance issues that are the most material to their business. These include issues that are focused on things like preparedness, disclosure and performance. You might think that by reducing carbon footprint, you automatically improve the "environment" sleeve. But that's not always the case. But by supplementing the direct carbon reduction with broader ESG ratings, we believe we've created a more robust measure of sustainability. So, we still look at the risk and return objectives, but we're also managing the aggregate ESG score, carbon footprint, reserves and even the green energy exposure.

Q: WHAT OTHER DEVELOPMENTS MIGHT BE NEXT?

A: Even though there's a big focus on decarbonisation at the moment, it's a relatively new area for most institutional investors –and it's an area that'll likely continue to develop and evolve. We think there are specific opportunities for further research, like incorporating broader criteria for resource efficiency.

Water intensity metrics and fleet efficiency— for example. Then, on the ESG side, we're excited about digging deeper into the subcategories, and evaluating how we construct industry-specific ESG scores. This will continue to build our understanding of how ESG scores may relate to financial performance.[4]

[4] Khan, M., Serafeim, G., & Yoon, A. (2015, March 24). "Corporate Sustainability: First Evidence on Materiality." *Harvard Business School Working Paper.* Number 15-073.



Russell Research

Decarbonisation 2.0:

Russell Investments' sustainable investing solution for the energy transition

This Q&A is based off of the research paper,

Decarbonisation 2.0: Russell Investments' sustainable investing solution for the energy transition, which is available for download on Russellinvestments.com.

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MCI-2017-07-31-1106 First used: June 2017