Q&A

Russell Investments' approach to managing reduced-carbon portfolios

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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 in 2015. Since then, we've seen interest expand in pretty much every part of the world. And as it has grown, this area of portfolio management has also evolved. There is 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: Basic approaches – such as divesting from companies that hold fossil fuel reserves or simply aiming for a lower carbon footprint than a standard benchmark – remain common. But sometimes those approaches aren't as effective as they should be. They can lead to a reduced exposure to renewable energy, for example, because some companies currently involved in energy production are among the best positioned to invest in renewable energy programs and are strongly incentivized to do so. Yet standard decarbonization might underweight these companies and lead to a renewable energy mix worse than that of the benchmark. Similarly, we've found that the naïve approach can sometimes lead to worse overall environmental, social and governance (ESG) scores; so, we wanted to find ways to address that as well.

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

A: There are three main strands to what we've done. We've added a Green Energy Score to increase the focus on renewables. We've introduced an explicit exclusion for coal, because coal is the least efficient fossil fuel in terms of CO_2 emissions for each BTU[1] generated, accounting for 44% of global CO_2 emissions while only supplying 30% of energy use.[2] And, finally, we've explicitly built broader ESG[3] scores – beyond carbon footprint – into the portfolio construction process in order to create better alignment with sustainability goals beyond carbon emission reductions.

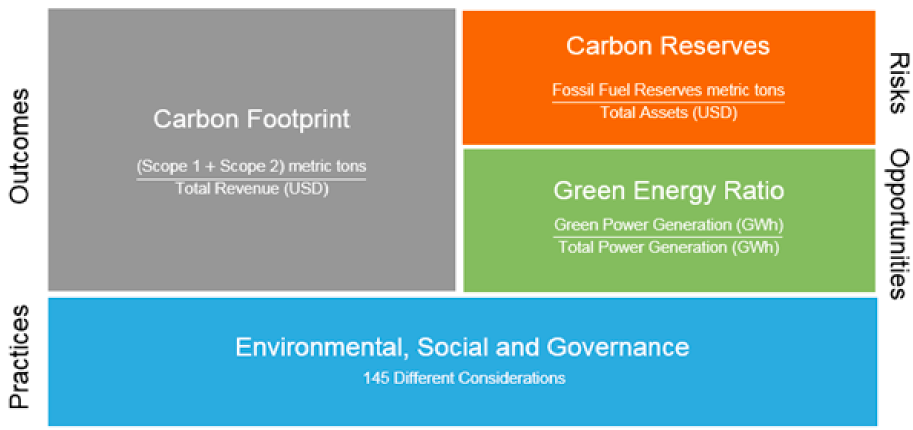
The enhanced process along with the interaction of these considerations across current and future threats and opportunities are summarized in Exhibit 1.

[1] British Thermal Unit

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

[3] ESG information utilized is sourced from Sustainalytics

Exhibit 1: Sustainability Considerations



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

A: 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. Twenty percent of companies are responsible for 86% of the aggregate carbon footprint in the MSCI World universe, and that skewness can get bigger when grouped by sector or even – although to a lesser extent – by country. So, we control for the size of active bets, otherwise simply divesting from the largest emitters would lead to large sector, industry and country bets relative to the benchmark.

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

A: Sustainalytics' ESG ratings give us another measure of how well issuers proactively manage the environmental, social and governance issues that are the most material to their business; issues that are focused on preparedness, disclosure and performance. You might think that by reducing carbon footprint, you automatically improve the "environment" sleeve; however, this is not always the case. As such, by supplementing the direct carbon reduction with broader ESG ratings, we believe we've created a more robust measure of sustainability. Thus, in addition to the risk and return objectives, we're also managing the aggregate ESG score, carbon footprint, reserves and green energy exposure.

Q: WHAT OTHER DEVELOPMENTS MIGHT BE NEXT?

A: Decarbonization is a relatively new area for institutional investors and one that will continue to develop and evolve. Specific opportunities for further research include incorporating broader criteria for resource efficiency (e.g., water intensity metrics and fleet efficiency). On the ESG side, evaluating subcategory materiality for the criteria used in constructing industry specific ESG scores will be an exciting area for further developing our understanding of how ESG scores are related to financial performance.[4] As data quality improves, and new concepts and challenges arise, we believe that these strategies will need to evolve and adapt accordingly.

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

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

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

Decarbonization 2.0

Russell Investments' sustainable investing solution for the energy transition

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

For more information:
Call Russell Investments at 800-426-8506 or visit **russellinvestments.com/institutional**

IMPORTANT INFORMATION

Q&A with Scott Bennett.

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