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# Index and Active for Climate Investing

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There are strong reasons for investors to employ both an index and active approach to climate investing. A combination enables investors to fully mitigate climate risks and to capture the upside potential of the climate transition, leveraging the best of both approaches.

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Climate investing does not have to be an either-or decision around index or active strategies. As with many portfolio objectives, ESG investing aims can be addressed using indexed, active, or a blend of approaches. There are strong arguments for adopting both an index *and* active approach in portfolio allocations to climate investing. As the industry evolves, climate investing no longer involves a binary investing choice. Importantly, we recommend investors employ a spectrum of climate solutions, as each approach can bring meaningful portfolio benefits from mitigation and adaptation by addressing both transition and physical risks as defined by the Task Force on Climate-Related Financial Disclosures (TCFD). In this article, we highlight how distinct approaches might be better suited for different dimensions of climate investing and how a combined approach provides a more nuanced way for investors to meet their investment as well as environment, social, and governance (ESG) objectives.

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## Dimensions of Climate Investing

Mitigation and adaptation are important dimensions of climate investing, drawing on both transition and physical climate risks. Mitigation refers to avoiding and reducing emissions in a portfolio, or among portfolio companies. For example, an investor might target a reduction in the carbon footprint, or absolute level of carbon emissions in a portfolio. Adaptation denotes a company's ability to position itself to take affirmative advantage of the climate transition. For instance, an integrated energy company might look to pivot its business model away from hydrocarbons and towards renewable energy sources. In terms of risks, the TCFD has divided climate-related risks into two major categories: transition risks, or those related to the transition to a lower-carbon economy and physical risks, or those related to the physical impacts of climate change. Transition risk could include a risk that the market for a company's product might disappear, or the risk that a company could get stuck with stranded assets. Index investing is well-suited to combine diversification and climate risk mitigation efforts with achieving some degree of adaptation. Active management, with all the means at analysts' disposal, is well-positioned to address transition elements, and hence target adaptation in an active context. It is a question of investor choice and degree for which pathway to choose. In the following sections, we will dig into each of these approaches in more detail.

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## Indexing Approach

Historically, indexed approaches have relied on backward-looking climate data, and therefore have been better suited to mitigation approaches, using metrics such as carbon intensity. Indexed approaches have been able to incorporate other constraints and objectives such as tracking error targets and sector exposures. For example, data on Greenhouse Gas (GHG) emissions has been among the earliest and most widely disclosed environmental data by corporates, and has also been aggregated and disseminated by a number of independent providers (e.g. see [GHG Emissions Dataset — GDP](#)). More recently, however, indexed approaches have evolved to incorporate more forward-looking measures, such as, for example, the Paris-Aligned Benchmarks (refer to our recent paper “[Understanding Paris-Aligned Indexes](#)”) which include decarbonization targets, and also take into account corporate target setting. These more forward-looking measures can be combined with traditional index technology, such as tracking error minimization by optimization. And as more information becomes available that is relevant to climate investing, the opportunity to build transparent, systematic approaches based on that quantifiable data will expand.

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## Active Approach

Recent years have seen great improvement in the availability of relevant climate-related information for investment purposes. Even so, the assessment of potential transition risk, as well as the potential effectiveness of companies’ adaptation efforts, are more subjective, and tend to rely on forward-looking and more qualitative measures. In a climate-focused world, companies will be pressed to develop credible transition plans and will be assessed on their progress under sharp scrutiny. Some companies may require new investments or restrictions on the path to Net Zero; others will be advantageously positioned to benefit from efforts to tackle climate change. Climate transition planning and competency will therefore become key areas of differentiation for companies — and key valuation drivers for all equities. In this evolving climate landscape there will be re-ratings, valuation dislocations, and corporate winners and losers, creating an environment ripe for forward-looking, active stock selection. Although these elements are being integrated in scalable data points for indexation as well, active strategies are a good fit for investors seeking to choose companies in a more hand-picked fashion that are well-positioned to weather — and thrive — in the climate transition. In short, for investors that have more tolerance for tracking error, want to access the cutting edge of climate transition, and gain exposure to new technologies that are well-positioned to be at the forefront of climate change in the future, we believe a discretionary active approach makes the most sense.

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## Asset Stewardship

For investors interested in expressing climate-related views in their portfolios, asset stewardship is a key consideration, and we think it should apply in both indexed and active contexts. Index managers, by their nature, are providers of long-term capital and have been shareholders in some companies for decades. Given their size and long investment horizon, index managers are uniquely positioned to engage with companies on their transition to Net Zero.

While active managers have the option to divest assets that fail to meet certain climate-related criteria, we think divestment should be considered a measure of last resort, especially when it comes to the climate transition. Fundamentally, we believe divestment is not sufficient to create genuine climate impact by itself. With divestment, investors lose their impact to bring about positive and lasting change via voting and engagement. Instead, companies can be bought by investors who lack a clear climate strategy, or they can go into the hands of private owners with no market scrutiny. Fear of large-scale divestment from institutional investors and other public market participants could lead companies to spin off their high-emitting divisions or go private (a practice we refer to as ‘brown spinning’). This concerns us because the ultimate effect in some cases could be to shelter companies from being positively influenced by shareholders in the context of climate change. Divestment is also a point-in-time approach that usually does not account for the direction of development. To read more about our views on this topic, refer to our piece “[Engage or Divest? The Question at the Heart of Climate Impact.](#)”

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Numerous academic studies find that engagement is a more effective strategy than divestment. For investors who are interested in realizing climate-related outcomes through stewardship activity, both index and active managers' asset stewardship programs can provide an avenue for influence with companies across countries and sectors.

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## **Conclusion**

There are strong arguments for considering both index and active approaches for climate transition portfolios. Each approach brings meaningful benefits and can be combined depending on investors' alpha targets, risk budgets, fee expectations, and governance approach. The tools of engagement and proxy voting are relevant to each approach. A combination of both active and index approaches can help investors to realize the best of each strategy, as they seek to address and harness both climate-related risks and opportunities within a portfolio context.

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