NORTHERN TRUST
ASSET MANAGEMENT

CASE STUDY

TURNING EMERGING MARKETS "GREEN" FOR A PENSION PLAN

"How can our pension scheme partner with an asset manager to create a flexible ESG emerging markets equity strategy that will evolve over time as our views on ESG evolve?"

The Client

One of the UK's biggest pension schemes.

With several million members, the client is one of the country's biggest pension schemes, representing a quarter of the workforce. They are at the forefront of green investment innovation, dedicating nearly half of their portfolios to climate-aware strategies.

The Challenge

To develop an ESG strategy for emerging market equities.

How to pivot to a low-carbon world

While they had a goal of offering environmental, social and governance (ESG) options across all areas of their defined contribution pension scheme, doing so for emerging market equities was especially challenging. Above all, the client wished to focus on shrinking their emerging markets strategy's environmental footprint in line with the goals of the UN Paris Agreement. Yet emerging markets' high number of oil & gas and mining companies had historically made this difficult. At the same time, they wanted to gain exposure to the newer companies benefiting from the transition to a low-carbon economy. The selected asset manager should be flexible, putting forward a solution that would be low cost and able to evolve over time with their developing views.

Our Approach

Create a proprietary emerging markets index to serve as a blueprint for the client's EM strategy.

Engineering a customized index

Taking a collaborative approach, we worked closely with the client from early 2020 to design a customized NT Emerging Markets Custom Climate Aware Index. This progressive and forward-looking index was built leveraging our 30 years of sustainable investing innovation, and would form the foundation of their new $1.3 billion ESG emerging markets strategy.

The initial goal was to progressively move to a carbon-neutral index in 10 years' time. Through an iterative process, we adjusted the strategy to balance their financial goals for the investment with their environmental values.

In an effort to guard against risks arising from climate change, we differentiated between two types of risk — physical risk and transition risk. From a physical perspective, the warming climate is already triggering droughts, storms and flooding that damage land, buildings and infrastructure. During the transition to a zero-carbon economy, the accompanying policy, legal and market changes will undoubtedly have a material financial impact on some businesses.

Our Solution

Utilize the NT Emerging Markets Custom Climate Aware Index combined with individual company analysis to balance financial objectives with environmental concerns.

Excluding low performers, over-weighting high performers

After an intense period of collaboration, the client selected a version of the NT Emerging Markets Custom Climate Aware Index that combined excluding the worst ESG stock performers and taking overweight positions in companies at the forefront of the energy transition. The index is highly flexible, so they can adapt their strategy to incorporate new research and evolving perspectives.

Using the MSCI Emerging Markets Index as a base, the custom index first deploys the exclusions. Afterwards, it applies tilts to over- or under-weight individual stocks. This happens in the following four stages:

1. Custom screening

The client opted to exclude companies operating in the following businesses from the index: civilian firearms, controversial weapons, conventional weapons, nuclear weapons, thermal coal and tobacco. It also excluded those failing to meet adequate corporate governance thresholds, as well as the UN Global Compact Principles.

2. Energy reserves tilting

This tilt underweights stocks in the index which have the greatest potential effect on the energy exposure.

3. Carbon intensity tilting

This tilts away from the companies with the highest carbon intensity and towards those with the lowest.

4. Green revenues and transition risk management tilting

This fourth dimension overweights those stocks with the greatest potential for green revenues in the areas of: alternative energy, energy efficiency and green buildings.

A MATRIX OF OPTIONS

	Sample Iteration 1		Sample Iteration 2		Sample Iteration 3		Sample Iteration 4	
Target	Stocks Excluded	Incremental Stocks Tilted*	Stocks Excluded	Incremental Stocks Tilted*	Stocks Excluded	Incremental Stocks Tilted*	Stocks Excluded	Incremental Stocks Tilted*
NT Custom ESG Exclusions	28	541	62	527	106	0	28	541
Energy	8	81	0	81	0	81	8	81
Carbon	0	23	0	0	0	116	0	246
Green Revenues	0	261	0	261	0	364	0	261
Total	**36**	**1,103**	**62**	**1,066**	**106**	**561**	**36**	**1,129**

* For illustrative purposes only. Tilts are not necessarily unique securities and describe the effect of each screen.

The Benefits

Greater focus on green technology and reduced exposure to high carbon intensity companies.

A positive environmental impact

The strategy tracks the NT Emerging Markets Custom Climate Aware Index that adapts Northern Trust's long-standing custom ESG approach to emerging markets. As such, the client's emerging markets strategy is expected to cut investment in traditional emerging markets companies with large oil or gas reserves and high carbon footprints. On the flipside, it can raise allocations to newer companies with greater commitments to clean technology and renewable energy. As the Plan owns the index it can choose to make alterations as the climate debate unfolds. Above all, it gives their UK pension savers a green option in emerging markets.

The Result

The client is on a path that can achieve their long-term, carbon neutral objective.

Meeting investment objectives

The end result was a low-cost strategy that keeps them at the forefront of green investment innovation. The client is positioning to meet their long-term investment objectives of being carbon-neutral by 2030 and hedging against systematic climate change risk.

Potential Emissions ex Met Coal	Carbon (Scope 1 & 2) Intensity	Alternative Energy	Energy Efficiency	Green Building	Transition Score
-86%	-31%	+32%	+31%	+67%	+3

Relative to MSCI Emerging Markets benchmark at the time of proposal March 2020.

Definitions:

Potential Emissions ex Met Coal: The potential carbon emissions of the fossil fuel reserves, excluding metallurgical coal reserves, owned by a company. It is computed as the sum of the potential carbon emissions of the thermal coal, total oil and total gas reserves owned by the company.

Carbon (Scope 1 & 2 Intensity): The company's most recently reported or estimated Scope 1 + Scope 2 greenhouse gas emissions normalized by sales in USD, which allows for comparison between companies of different sizes.

Alternative Energy: Products, services, or infrastructure projects supporting the development or delivery of renewable energy and alternative fuels.

Energy Efficiency: Products, services, infrastructure, or technologies that proactively address the growing global demand for energy while minimizing impacts to the environment.

Green Building: The design, construction, redevelopment, retrofitting, or acquisition of 'green' certified properties – subject to local green building criteria.

Transition Score: A company level score that measures a company's level of alignment to the Low Carbon Transition. Companies with higher Low Carbon Transition score are more aligned with the Low Carbon Transition compared to the companies with lower scores. (Score: 0-10)

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