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AN INTRODUCTION TO LOW CARBON AND FOSSIL FREE PASSIVE EQUITY

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Appendix 1

MARSH & McLENNAN COMPANIES

BACKGROUND – WHY HAVE LOW CARBON AND FOSSIL FREE INDICES EMERGED NOW?

Mercer's recent study, '*Investing in a Time of Climate Change*'[1], highlighted that investors should consider the risks posed by climate change; in particular policy risks. Following the positive outcomes from the recent meeting of global leaders in Paris, where a new global agreement to manage carbon emissions and tackle climate change was reached[2], it is anticipated that the policy response to managing climate change will become more urgent in the coming years.

Some of the key financial risks associated with climate change are rising carbon prices and the potential for "stranded assets" i.e. the possibility that a proportion of existing fossil fuel reserves will never be utilised due to changes in regulation, demand and technology.

Accordingly, investors are increasingly considering how to hedge their portfolios against the risks posed by climate change as well as seeking positive investment opportunities aligned with anticipated shifts in energy use and technology.

In a world where the cost of carbon is likely to rise, managing exposure to high carbon companies is an intuitive step to take.

One approach investors can take is to reduce the carbon intensity of their portfolios over time, also known as "portfolio decarbonisation". The benefits of this approach include:

- A portfolio that is less susceptible to increasing carbon pricing, stranded assets and/ or related regulation.
- Supports the flow of capital to a resilient low-carbon economy and may help to address the market mispricing of carbon.
- Produces a market signal that incentivises companies to develop and invest in low carbon and clean technologies, influences policymakers and also helps to catalyse a new standard for other institutional investors.

[1] Available at: http://www.mercer.com/insights/focus/invest-in-climate-change-study-2015.html

[2] Available at: http://www.mercer.com/content/dam/mercer/attachments/global/investments/investing-in-a-time-of-climate-change-dispatch-from-cop21-mercer-2016.pdf

WHAT ARE LOW CARBON AND FOSSIL FREE INDICES?

Low carbon indices are designed to track broad market indices but with lower carbon footprints, in some cases significantly lower.

The primary benefit of a low carbon index is that it can be an important first step for investors to take to reduce the carbon intensity of their portfolios.

Additional benefits include that they are relatively low cost (albeit typically a little more expensive than broad market indices), relatively simple to understand (i.e. asset owners can point to a clear carbon reduction) and relatively easy to implement.

In a world where the cost of carbon is likely to rise, managing exposure to high carbon companies is an intuitive step to take. However investors need to consider carefully the methodologies and outcomes of these specialist indices:

- The indices are focussed on risk management and do not capture the opportunity side of the equation (i.e. by shifting from high carbon to lower carbon companies, investors may not necessarily gain exposure to companies leading on the development or provision of products/services best positioned to succeed in a lower carbon environment).

- To date, the indices are typically based on a market-capitalisation weighted methodology, and therefore bring with them the same issues that core market cap benchmarks have in this context (e.g. that investors end up with more exposure to overvalued companies as price fluctuates).

- Investors should be aware that whilst low carbon indexes are designed to track parent indices, the different construction approaches can lead to varying degrees of tracking error. During periods of extreme stress or market dislocation the performance of low carbon or fossil free indices could deviate significantly from the mainstream benchmark.

- Low carbon indices remain subject to concerns around data availability and transparency. The reporting of carbon emissions remains relatively inconsistent (particularly in emerging markets) and hence data is subject to assumptions and sometimes opaque standardisation methodologies.

OVERVIEW OF INDEX APPROACHES

Low carbon indices and fossil free investment solutions are a hot topic right now: multiple, competing indices have emerged over the last two years, with various investment vehicles launched. In our view, there are three broad categories of low carbon indices: Broad Market Optimised; Best-in-class and Fossil Free. We have set out in the table below a summary of the likely investor suitability and appeal of the different approaches.

Approach	Example Indices	Likely to be suitable for a client that….
Broad Market Optimised	• MSCI Low Carbon Target • FTSE UK Carbon Optimised	**… does not have an exclusion policy in place.** – By starting with the full universe, the construction methodology is consistent with the way an investor with a focus on ESG integration applies its responsible investment approach more generally across its investments. **… is seeking reduction in the exposure to carbon emissions and to carbon reserves.** **… is seeking to reduce exposure to fossil fuel related carbon emissions.**
Best-in-Class	• MSCI Low Carbon Leaders • S&P 500 Carbon Efficient Index	**… is able to accommodate negative exclusions.** – Typically such indices exclude the worst performers (in terms of carbon emissions/ reserves) from each sector and re-weight across the sector. **… wants an approach that considers carbon efficiency across all sectors (rather than focus on the sectors with the highest carbon emissions).** **… wants to send a clear signal to stakeholders that the largest carbon emitters are not present in the portfolio.**
Fossil Free	• MSCI ex Fossil Fuel • MSCI ex Coal • FTSE ex Fossil Fuel • FTSE ex Coal	**… is able to accommodate negative exclusions.** – Typically more applicable to foundation/ endowment clients. **… wants simple and transparent methology.** **… is committed to fossil fuel divestment based on a full review of their investment beliefs.** – These indices may be appropriate as a benchmark for active management.

SUMMARISING MERCER'S VIEW

- The use of low carbon or fossil free indices is only one of the many tools available for tackling climate change risks. Low carbon and fossil free index strategies do not typically offer exposure to investment opportunities aligned with a shift to a low-carbon economy.

- These indices may not necessarily bring an outperformance premium in the traditional sense. The "premium" is reduced carbon exposure rather than performance. This reduced exposure may be rewarded in financial terms, all else equal, as policy measures develop to reward lower carbon activities.

- Investors need to be fully aware of the underlying construction methodology – in particular, fossil free does not have one consistent definition across asset owners, index providers or investment managers.

- The use of such indices should not be seen as equivalent to, or as a substitute for, actively managed equities with a high level of ESG integration. Many actively managed strategies with strong ESG integration do not have exposure to high carbon sectors as a result of their idea generation and portfolio construction process and are also able to capitalise on investment opportunities that specifically address climate change and low carbon.

- **Low carbon indices** are expected to track (subject to tracking error limits) broad market indices with the potential for outperformance if policy measures develop to reward lower carbon activities. We consider low carbon indices to provide a scalable hedge against climate change risk for passive investors, without necessarily forfeiting returns in the interim.

- **Fossil free indices** are expected to show significant deviation from broad market indices. These indices may be appropriate for asset owners committed to divesting from fossil fuels and these indices may also be suitable as a benchmark for active management. Given their exclusionary nature, fossil free indices have performed well in the recent environment of falling oil prices but would be expected to underperform if there was a reversal to the current trend.

  Both low carbon and fossil free indices can serve to meet external commitments to align with a decarbonising economy and help to send a strong signal to stakeholders that they are proactively managing climate risk.

There are several questions for investors in determining the most appropriate approach, including:

- What risks do low carbon/ fossil free indices protect against?
- Are there any unexpected consequences of the construction methodology?
- Could an investor be taking unexpected biases as a result?

Mercer has reviewed the indices provided by the leading index providers and has assessed the current investment strategies available. Please contact us if you would like further information.

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For more information about this report and related content, please contact:

Kate Brett
kate.brett@mercer.com
+44 (0)20 7178 7185

Mercer Investments
Tower Place
London
EC3R 5BU

MARSH & McLENNAN COMPANIES