InfluenceMap

Climate Funds and Fossil Fuels

An analysis of climate-themed funds suggests the need for oversight of this emerging sector

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Executive Summary

- The ESG (environment-social-governance) fund sector is a fast-growing market. Morningstar estimates that assets in ESG themed mutual funds now exceed $1 trillion, while a 2019 BNP Paribas survey found 75% of asset owners invest in such funds. In light of this growth, there is considerable anticipation from a range of stakeholders, not least policy makers in the EU, that ESG funds will both meet buyers' expectations and drive genuine impacts in the real economy. This is particularly true of climate-themed funds, which form the subject of this research.

- The report identifies 118 climate-themed funds with an aggregate AUM of US$18Bn and examines the presence of fossil fuel reserves owned by the companies held by these funds. As a comparative indicator between funds of differing size, the analysis uses Thermal Coal Intensity (TCI) and total Fossil Fuel Intensity (FFI) metrics. While fossil fuel companies are not necessarily barred from climate funds for legal or other reasons, purchasers of such funds would likely expect these intensity metrics to be minimized in a product marketed under a climate theme.

- At the extreme end, two funds (each with over $100Mn in AUM) marketed by Asia-based Fullgoal and Lion Fund Management companies were found to have TCI figures of 38,000 and 26,000 tons CO_2/$Mn AUM respectively through holdings of Chinese mining companies like Shaanxi Coal and Yanzhou Coal Mining. These funds are over 50 times more intensive than a mainstream fund based on the MSCI World Index of global large cap equities. The research also identifies two State Street funds marketed as "fossil fuel reserves free" and based on MSCI indices which have stakes in major energy and mining companies active in thermal coal, including RWE, Vale and Sasol.

- On the other end, many asset managers selling climate funds appear to have actively eliminated companies controlling fossil fuel reserves from their funds. These are led by BNP Paribas, with an aggregate $2.1Bn AUM in climate-themed funds, Finland's Nordea ($1.6Bn), as well as European players Franklin Templeton, UBS, and Pictet, all with $500Mn or more in climate funds.

- The research on climate funds highlights the need for greater oversight of the ESG sector. There remains huge variation in the terms used to market funds as climate themed, including "low carbon", "climate aware", and "fossil fuel free". Clear discrepancies between these labels and fund contents (for instance, the presence of coal mining companies in "fossil fuel reserve free" funds) indicate that more stringent advertising standards may be pertinent.

- The research examined only those funds marketed with a climate-theme, many of which appear to be passive in strategy. However, it is noted that many climate-themed funds, such as Legal & General's Future World Fund, remain intentionally invested in fossil fuel companies and pursue active engagement with these companies to drive impact. Future research should thus explore the complex matter of how climate (and ESG) funds can materially impact and drive positive change in the real economy via engagement with the companies in the portfolios.

Introduction

ESG and Impact Investing

The ESG (environment-social-governance) and impact fund sectors are fast-growing, and are intended to offer individual and institutional asset owners the opportunity to invest in line with their ethical and sustainability preferences. In 2018, the Global Sustainable Investment Alliance (GSIA) identified nearly $31 trillion managed under 'responsible' investment strategies globally - an impressive 34% increase from the total value in 2016. ESG represents a specific sub-sector of this total pool, with MorningStar estimating that the value of explicitly ESG mutual funds now exceeds $1 trillion (as of November 2018). According to Bloomberg, investor interest in ESG funds drove a 37% annual increase in assets under management for the sector in 2017, compared with a 23% increase in the mainstream MSCI World Index. BNP Paribas's "ESG Global Survey 2019" of nearly 350 investors found a similar uptick in investment, with 75% of asset owners and 65% of asset managers invested in ESG and Responsible Investment (RI) funds. Within the ESG universe, InfluenceMap has identified $18Bn in assets under management held in specifically climate-themed listed funds as of June 2019.

The ESG segment of the fund market is clearly important, not only as a source of growth for the fund management sector more broadly, but increasingly as a focal point for regulators and other stakeholders in driving sustainable finance and precipitating a shift in investment from brown to green assets in the real economy. It is therefore critical that the ESG sector develops in a manner that generates the impacts in the real economy that it claims to and retains the trust of both individual and institutional investors who expect to see these impacts alongside their financial expectations. Maintaining this trust and integrity has emerged as a priority for EU regulators, who are looking closely at the potential need for stronger oversight within the ESG fund sector (discussed in detail in the next chapter).

Opportunities and Barriers

Recent studies by mainstream investment houses consistently show that retail investors have a strong and growing interest in sustainable products. Schroders' 2017 Global Investor study found that 78% of respondents considered sustainable investing important, an increase from 64% in 2012. In a second 2017 survey by Morgan Stanley, 40% of retail investor respondents stated they would 'actively seek' sustainable investment funds. Millennials (individuals born roughly between 1981 and 1996) have consistently expressed an even higher interest in ESG than the broader population of investors. According to a 2017 study by the Wisdom Council, two thirds of millennials stated they would choose to invest in ESG funds if readily available.

However, there remain significant barriers to meeting this growing demand. The same Wisdom Council study found that a quarter of investors cited a lack of understanding as a barrier to investing in an ESG or impact strategy, while a majority of investors deemed industry terminology and jargon unhelpful for understanding what funds do or how they are managed. A further barrier is the prevalence of the 'Trade-off Myth': Arabesque and Morgan Stanley have found that between a third and a half of all investors believe integrating ESG will lead to loss of returns, despite consistent data contradicting this. Research by think tank 2 Degrees Investing Initiative (2DII) found that obstacles to the expansion of ESG include lack of trust in the financial system, availability of clear options, and advice and information situated in the appropriate time and place in an investors' financial decision making. As the 'end clients' for many institutional investors and a strategic source of capital for commercial banks, capitalizing on the willingness of retail investors to support climate goals to create firm constraints for financial intermediaries would aid substantially in aligning the finance sector with climate goals.

Organizations such as 2DII have argued that a majority of green thematic funds appear to be "impact washing" – marketing financial products without substantiating their actual impacts. In the 2019 paper 'Impact Washing Gets A Free Ride', 2DII found 85% of ESG-themed funds analyzed made unsubstantiated or misleading claims in violation of existing market regulations, namely the 'Unfair Commercial Practices Directive', which states a practice is misleading if it contains false information, is deceptive, or is likely to cause a consumer to make a "transactional decision" they otherwise would not have. These findings, in combination with those of other similar research efforts, suggest the need for financial regulatory reform, clear information provision, and consumer education in order to trigger meaningful and integrity-driven growth within the ESG fund and financial product market.

The analysis of climate-themed funds conducted by InfluenceMap and described in subsequent chapters reinforces the research detailed above. The data suggest the ESG fund market may require closer oversight to ensure its evolution both retains the trust of investors and drives the necessary impacts in the real economy. The following section details key emerging strands of regulation within the EU designed to achieve these aims.

Regulation of the ESG Fund Market in the EU

The EU Sustainable Finance Action Plan was published in March 2018, building on the final recommendations of the High-Level Expert Group on sustainable finance. The core objectives of the Action Plan are to reorient capital flows toward sustainable investments; to manage financial risks from climate change and other environmental threats; and to foster transparency and long-term strategies in financial activities.

In May 2019, the European Commission published five legislative proposals, four of which have been finalized. Several of these regulatory strands are acutely relevant to the ESG fund market and should thus be scrutinized by investors before they enter into force in 2021-2022.

- **Oversight of investor disclosure**: The EU has introduced an amendment to an EU Directive mandating that "financial market participants" publicly disclose how they have integrated sustainability risks into their investment decision-making process, as well as the extent to which the as-yet unfinalized EU Taxonomy for Sustainable Activities has been used to define their products' sustainability. The amendment will require investors to disclose: their ESG-related risks; a summary of their engagement policy with investee companies; and evidence supporting the ESG claims associated with their financial products (notably, 'green' and climate-themed funds). Additionally, large investors will be required to disclose the environmental and social impacts of all their financial products, their due diligence processes regarding these impacts, and their degree of alignment with the Paris Agreement. The EU will likely release more details regarding this in 2020.

- **The EU Taxonomy for Sustainable Activities**: which will define what constitutes a sustainable economic activity, is still under negotiation by EU institutions and is slated to enter into force in 2020-2021. The disclosure requirements for investors cited above will very likely be tied to the taxonomy where applicable (e.g. for green and climate-themed funds). Significantly, while the most recent Taxonomy Technical Report provided a clear outline concerning which economic activities are 'green' (in other words, contributing to the transition to a low-carbon economy), it did not define the 'brown' activities that should be excluded from financial products marketed as environmentally or climate-themed. This means that, under the incoming amendment, an investor could disclose information on green assets without disclosing the details of the portfolio value exposed to those activities *not* within the scope of the Taxonomy, including activities such as thermal coal mining and combustion.

- **Benchmark indices:** (e.g. those from S&P, MSCI, FTSE Russell) will be required to disclose their performance against climate benchmarks, defined as an investment benchmark that reflects specific objectives relating to greenhouse gas emissions and the transition to a low-carbon economy through in the process of portfolio composition. This policy is designed to allow indices to be judged equally on their environmental credentials despite their varying characteristics. There is also likely to be implementation of a recommendation of the Technical Expert Group that mandates minimum ESG disclosure requirements for all benchmark indices. There will be additional requirements for any indices looking to disclose their performance against the two newly constructed EU climate performance benchmarks: the EU Climate Transition Benchmark (EU CTB) and EU Paris-Aligned Benchmark (EU PAB). It is likely that any index marketed under a climate theme will have to comply with one of these two regulated climate benchmarks to be viewed as legitimate by the market, although it should be noted that their use is not mandatory.

- The EU Ecolabel is an EU-wide voluntary labeling scheme which is currently under preparation for its application to the fund management sector. These ongoing outcomes of this process suggest the EU Ecolabel as applied to funds should, in practice, apply to the top 10-20% best environmentally performing products. It will use the Taxonomy and EU Green Bond Standard to define green investments and combine these with thresholds defining a minimum % of investment in green activities. It will likely also incorporate exclusion lists for activities deemed incompatible with the Eco-Label objectives.

Climate-Themed Funds and Fossil Fuels

Introduction

This research highlights the need for greater oversight, including the potential for EU regulation, of the inclusion of 'non-green' assets in 'green' financial products, particularly those activities that could be considered clearly misaligned with the ambition of the Taxonomy and with the goals of the Paris Agreement. This report is part of a wider project to examine the robustness of financial portfolios in the context of the transition to a low carbon economy. The project, called FinanceMap, is being conducted in collaboration with financial think tank 2 Degrees Investing Initiative (2DII) and the WWF European Policy Office, with a launch planned for late 2019.

This research analyses 118 funds marketed under a climate- related theme to retail investors globally. In light of the IPCC's October 2018 Global Warming of 1.5C report and its implications of drastic cuts in the use of fossil fuels (particularly thermal coal), this research examines climate funds through the lens of fossil fuel reserves ownership by companies in the fund portfolios. It is reasonable to assume that purchasers of such funds would expect exposure to fossil fuel reserves within the funds to be minimized in line with the manner in which the funds are named and described in fund marketing materials.

Methodology

To understand fossil fuel ownership patterns, this research considers a group of roughly 300 publicly listed companies which control the largest quantities of fossil fuel (thermal coal, oil and gas) reserves and production globally. A dynamic online spreadsheet documents these 300 companies, with all data taken from the latest financial filings (registration required).

These assets are then linked to a universe of 60,000 listed funds, as well as the world's 4,000 largest asset managers. The methodology traces physical assets independent of market price fluctuations. The companies held by the equity funds and the sizes of the stakes held are taken from publicly available data sources (see here for details of our ownership data sourcing methodology).

The research provides a range of metrics and analysis designed to better inform the climate campaign community and the strategies of climate-concerned financial institutions.

- The *thermal coal intensity* (TCI) is defined as the aggregate thermal coal reserves effectively owned by the fund through its holdings in companies that own these assets relative to the size of the fund. Expressed as tons CO_2 equivalent emissions per $Mn Assets Under Management (AUM).

- The *fossil fuel intensity* (FFI) is similarly defined as the aggregate fossil fuel (thermal coal, oil, gas) reserves effectively owned by the fund through its holdings in companies that own these assets relative to the size of the fund. Expressed as tons CO_2 equivalent emissions per $Mn AUM.

- The *potential total emissions* (PTE) represents the aggregate thermal coal, oil and gas reserves within the companies held by the fund. Expressed as tons CO_2 equivalent emissions.

The first two metrics (TCI and FFI) allow for like-for-like comparison between funds of different sizes by scaling the funds' effective ownership of fossil fuels to the size of the fund, while the PTE metric is an absolute measure, and reflects the total potential emissions associated with the fund's holdings in companies controlling fossil fuel reserves. Full details of the methodology may be found at this FAQ page, including conversion factors for thermal coal, oil and gas reserves and CO_2 equivalent emissions.

The research examined 118 equity funds worth an aggregate $18Bn (as of June 2019) and marketed using a range of climate-focused terminology. The terms used to identify these funds are listed in the box below.

"carbon constrained", "carbon efficient", "carbon momentum", "carbon neutral", "clean energy", "climate", "climate aware", "climate change", "climate leaders", "climate solutions", "climate strategy", "fossil fuel free", "fossil fuel reserves free", "fossil smart", "low carbon", "sustainable", "sustainability"

An immediate point of concern raised by the research is the diversity of terminology used to market funds with an audience of climate-concerned investors. There are presently no regulatory restrictions in the EU on the use of such terminology in the labelling and sale of ESG or climate-specific funds. An analogy may be drawn with consumer markets for organic products during their early emergence on the market in the 1970s and 80s. To begin with, the word "organic" was used widely and largely indiscriminately for marketing purposes until regulators saw fit to closely regulate its use in labels and marketing materials. It may be that a similar approach is needed in the ESG, and particularly the climate-themed fund market, to avoid confusion and allow like-for-like, informed comparisons of funds by investors.

Results

Full details of the 118 funds examined, including their associated asset managers, assets under management, and the three metrics defined above (TCI, FFI, PTE) can be found in this online spreadsheet. The table below provides a summary, by asset manager, of the results (top ten asset managers in terms of climate funds are listed).

The inclusion of companies that hold reserves of thermal coal as their assets in climate-themed funds is somewhat controversial. While labelling funds with terms such as "low carbon", "climate change" and "clean energy" does not specifically indicate the exclusion of such companies, climate-aware buyers would understandably expect funds marketed as "fossil fuel free" not to contain such holdings.

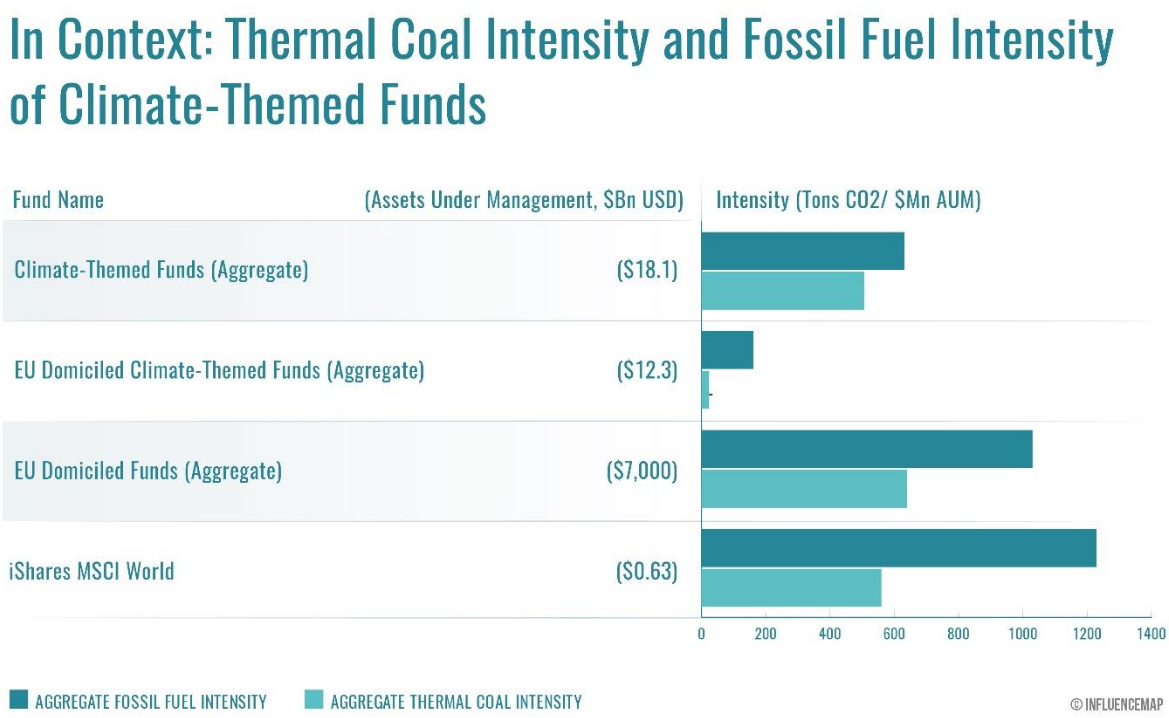
Climate Funds (Over $100Mn AUM) with the Highest Fossil Fuel Intensity

Fund Name	Fund Manager (Main Base)	Fund AUM ($Mn, 06/2019)	Fossil Fuel Intensity (Tons CO_2/$Mn AUM)	Thermal Coal Intensity (Tons CO_2/$Mn AUM)	Potential Total Emissions (Tons CO_2)
Fullgoal Low-Carbon New Economy Mixed Fund	Fullgoal (Hong Kong)	134	38,000	38,000	5,000,000
Lion Low-Carbon Economy Fund	Lion Fund Management (China)	137	29,000	26,000	4,000,000
CPR Invest – Climate Action A Acc	CPR Asset Management (France)	235	1,400	0	325,000
Amundi Index Equity Europe Low Carbon	Credit Agricole (France)	133	1,300	0	170,000
Northern Trust Emerging Markets Custom Low Carbon Optimised Equity	Northern Trust (US)	1,096	820	210	900,000
Sarasin Climate Active Endowment A Acc	Sarasin & Partners (UK)	248	320	0	80,000
iShares MSCI ACWI Low Carbon Target ETF	BlackRock (US)	455	280	125	126,000
ACS World Low Carbon EQ Tracker X2 Acc	BlackRock (US)	490	260	90	129,000
State Street Low Carbon ESG International Equities Index	State Street (US)	184	125	120	23,000
SPDR S&P 500 Fossil Fuel Reserves Free ETF	State Street (US)	365	6	6	2,000

Note: figures in the table above are rounded.

Full results are contained in this online spreadsheet. The group of 118 funds identified are managed by 65 different asset managers or financial groups. The climate-themed funds containing fossil fuels are limited to 15 of these financial groups, including State Street, BlackRock, and HSBC, with 22 funds in total exposed to fossil fuels. 50 of the 65 financial groups identified as offering climate-themed funds did not have exposure to fossil fuel reserves through these funds. It may be that these funds are actively managed or actively exclude fossil fuel companies from the indices used in the funds' construction. The financial groups with the largest AUM in climate-themed funds and which have no fossil fuel exposure within these funds are: BNP Paribas ($2.1 Bn AUM in climate-themed funds), Nordea ($1.6Bn), Franklin Templeton ($706 Mn), UBS ($683 Mn), Pictet ($592 Mn) and Schroders ($492 Mn).

The numbers in the table above may be placed in the context of the wider fund management sector with the following comparisons. It is noted that the aggregate thermal coal intensity for the 118 climate funds identified by this research is roughly equivalent to that of the iShares MSCI World ETF, which tracks the MSCI World Index of global large cap equities, and comparable to that of the wider EU domiciled fund universe. Notably, EU-domiciled climate funds do have a significantly lower aggregate FFI and TCI than the other domiciled climate funds.



The Role of Indices

To construct these funds, asset managers often rely on external index providers such as MSCI and S&P, which have developed a range of indices for this purpose. The major climate themed indices are listed below with their objectives, as declared by the index companies themselves.

- MSCI ACWI Low Carbon Target Index: managing potential risks associated with the transition to a low carbon economy.
- MSCI EAFE Ex Fossil Fuels Index: excluding companies that own oil, gas and coal reserves.
- MSCI Emerging Markets Ex Fossil Fuels Index: excluding companies that own oil, gas and coal reserves.
- MSCI World Low Carbon Leaders Index: excluding companies with the highest carbon intensity and those with the most carbon reserves per dollar of market capitalization.
- S&P 500 Fossil Fuel Free Index: measuring the performance of companies in the S&P 500 that do not own fossil fuel reserves.
- FTSE Global Climate Index Series: constituent weights adjusted for fossil fuel reserves, carbon emissions, green revenues.

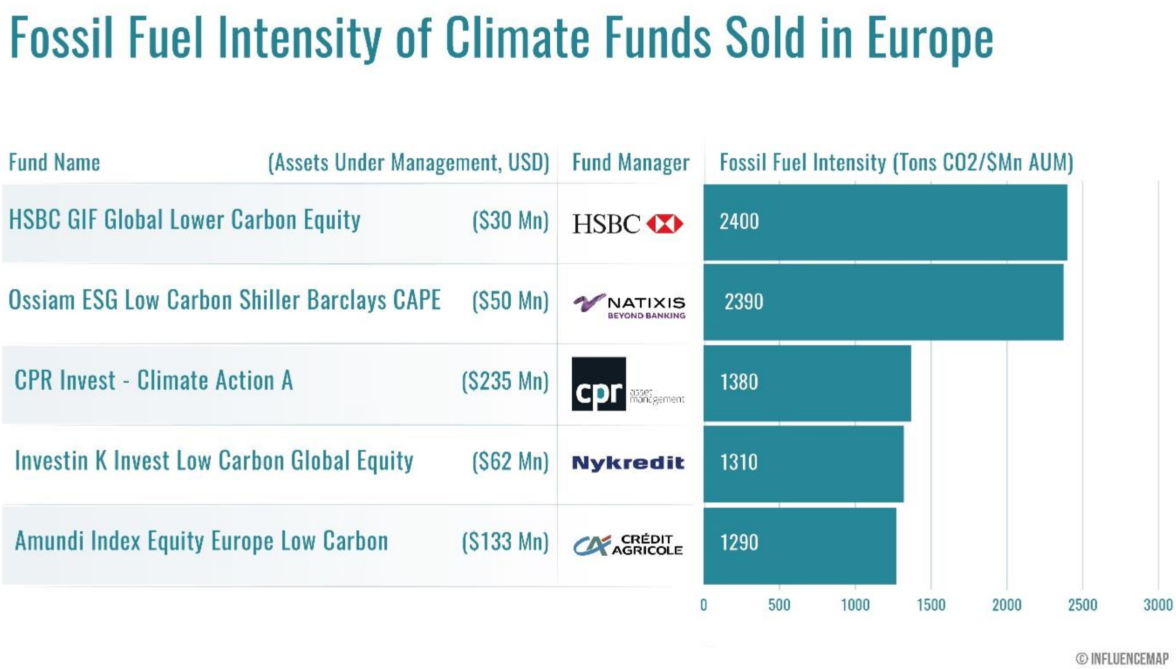
Leading asset managers BlackRock (iShares) and State Street make extensive use of these indices in creating their climate fund products, while others, like the asset management arms of HSBC, Credit Agricole and BNP Paribas, appear to utilize in-house indices. The full make up of these indices are generally not publicly available; however, it is likely that a significant driver of the presence of companies controlling fossil fuel reserves in climate themed funds is the use of indices to construct the funds.

It should be noted that most of the climate-themed funds connected to S&P and MSCI indices identified as containing fossil fuels are 'optimized' with respect to the method by which they track their affiliated index. That is, the portfolio may be 'optimized' by a fund manager to replicate the index using a representative sample of securities, rather than the exact composition of the index. Given that the degree of input implied by 'optimization' is variable, it is uncertain whether the inclusion of fossil fuel holdings in the index funds originates with the fund manager or the index provider.

Climate-Themed Funds Sold in Europe

The following graph highlights the climate-themed funds with the highest Fossil Fuel Intensities (FFI) available directly to retail investors in the EU.

The funds featured below are marketed with the labels 'Low Carbon' or 'Climate Action'. While not explicitly suggesting the elimination of fossil fuel exposure, investors would likely be concerned at the inclusion of major fossil fuel producers in the portfolio of a fund with a 'Low Carbon' label. For instance, HSBC's GIF Global Lower Carbon Equity fund has a stake in BHP, a company responsible for the production of 34 million tons of thermal coal annually. The fund's prospectus states that it strives for a lower carbon footprint than its respective mainstream benchmark, the MSCI World Net, by reducing exposure to companies with the highest carbon emissions, and that it "assesses all stocks in the fund for their carbon footprint and ESG risks."

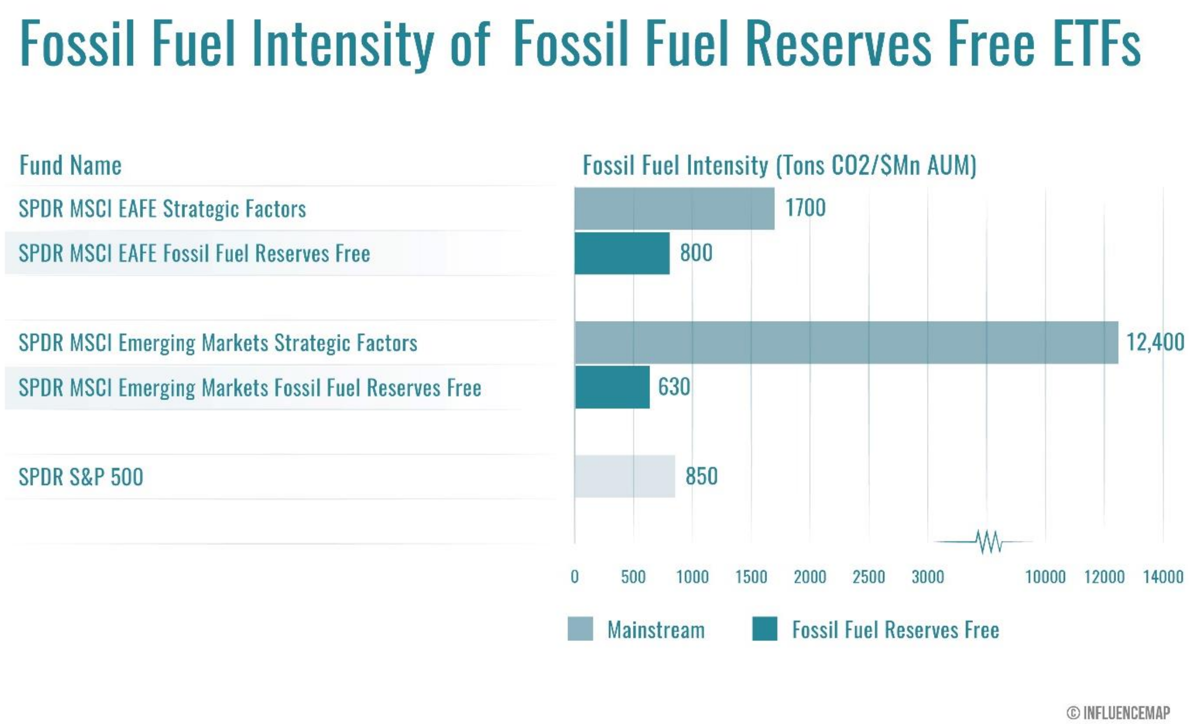


Fossil Fuel Reserves Free Funds

While the inclusion of companies with fossil fuel reserve assets in funds with labels such as "low carbon" or "clean energy" is certainly surprising, it is noted the labels do not explicitly indicate the exclusion of such companies. However, investors would reasonably expect funds marketed as "Fossil Fuel Reserves Free" not to contain such holdings.

The research identifies two State Street funds (SPDR MSCI EAFE Fossil Fuel Reserves Free ETF and SPDR MSCI Emerging Markets Fossil Fuel Reserves Free ETF) – worth a combined $100m – that contain fossil fuel reserves through holdings in companies including RWE and mining giant Vale. Both funds rely on MSCI fossil fuel reserves free indices for their construction. Details of the composition of these indices are not disclosed by MSCI; however, State Street does publish the holdings of most of its listed funds in the ETF section of its US site (note: access to certain funds may be restricted for EU users).

The graph below shows the Fossil Fuel Intensity of both funds, placing them in context with the respective mainstream funds from which they are derived, as well as State Street's flagship $260Bn SPY ETF, which is based on the S&P 500 index of the largest US companies. Key details concerning the funds' holdings are outlined in the chart and comments below.



- The two funds contain fossil fuel reserves through stakes in companies including RWE, Vale, Sasol and chemicals giant BASF.
- The 'SPDR MSCI EAFE Fossil Fuel Reserves Free' ETF holds over 3,000 shares in RWE – the single largest polluter in Europe - which is engaged in both the production of thermal coal and coal-fired power generation. The marketing factsheet accompanying the fund (available on State Street's US website) states in its 'Key Features' that the fund represents the "first ever international developed markets fossil fuel reserves free ETF."
- The 'SPDR MSCI Emerging Markets Fossil Fuel Reserves Free' ETF derives a majority of its fossil fuel exposure from its stake in Sasol, an integrated energy and chemical company with thermal coal, oil and natural gas assets, and which is a global market leader in coal-to-gas conversion process.
- Although both of the 'fossil fuel reserves free' funds identified have a lower FFI than their respective mainstream counterparts, it is noted that both are comparable in fossil fuel intensity to State Street's flagship $260Bn SPY STF, based on the S&P 500 index of the largest US companies.
- When only exposure to thermal coal is considered, the two 'Fossil Fuel Reserves Free' funds are in fact 100 times as thermal coal intensive as the SPY.
- The MSCI indices on which the State Street funds are based state they are a "*benchmark for investors who aim to eliminate fossil fuel reserves exposure from their investments due to concerns about the contribution of these reserves to climate change*."

Conclusions

The EU appears to be the primary region where tighter regulation of the ESG fund management sector is being considered and implemented. The issues highlighted by this research regarding climate-themed funds suggest closer oversight of the sector is needed. This could include the development of a pathway for discerning and regulating the impact of these funds on the real economy and on actual emissions reductions, particularly as several pieces of research cited in this report indicate real world impact is a key motivator for investors in climate and ESG funds. The following highlights three areas where mechanisms to drive improvements could be best placed.

- Comparability - There exists a huge variation in the terms used to market climate related funds from phrases containing "low carbon", "clean energy", "climate", "fossil fuel free" and others. It therefore remains difficult for fund buyers to easily determine what these descriptors mean in practice, both relative to each other and to their own investment goals and ethical preferences.

- Advertising - Variation in terminology notwithstanding, the research cited in this report evidences clear expectations from buyers that specific marketing terminology used in fund advertising should translate into corresponding features in the product, in this case the fund. The presence of thermal coal mining and energy companies such as Germany's RWE in funds marketed as "fossil fuel reserves free" (including the State Street funds noted in this research) may be considered in the context of various norms and regulations relating to advertising standards. It may be that the EU Ecolabel as applied to the ESG fund sector with use of the Taxonomy and Green Bond Standard to define green investments will address these issues.

- Impact – 2 Degrees Investing Initiative's 2019 research paper 'Impact Washing Gets A Free Ride' found 85% of ESG themed funds analyzed made unsubstantiated or misleading claims on the substantive impact of the funds. This research did not consider the real-world impact claims - where they may exist - of the 118 funds examined in detail. However, according to the prospectuses (where available) of the fossil fuel-containing climate-themed funds identified by this research, many aim to reduce carbon emissions by assessing the carbon footprint of companies in the portfolio. As outlined by the Impact Washing report, the European Sustainable Investment Forum (Eurosif) suggest that impact investing should meet the criteria of intentionality, additionality, and suitable measurement. In some funds, such as Legal & General's Future World Fund, rather than reducing simple emissions exposure strive for impact through active, strategic engagements with emissions-intensive companies in the portfolio. The issue of how to define and measure the impact of financial products on the real economy will be of increasing importance as expectations on finance to drive climate impact rise.