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Wespath | BlackRock

Low-Carbon Economy Transition Ready Investment Strategy

a general agency of The United Methodist Church

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Investment Context

What is the transition to the low-carbon economy?

The transition to the low-carbon economy refers to the global shift to a society that is more efficient in producing goods and services, one that is less reliant on carbon dioxide (CO_2) emissions, and the "decoupling" of economic growth from emissions. While global gross domestic product and emissions have historically been linked, we have recently witnessed a change. For example, the U.S. economy grew by more than 10% from 2008 to 2015, while CO_2 emissions from the energy sector fell by 9.5%.[i] Globally, energy-related carbon dioxide emissions were flat for a third straight year in 2016 even as the global economy grew 3.1%.[ii] This transition is expected to continue, and by some forecasts, further accelerate, due to concerns about climate change.

What is driving the low-carbon transition?

Regulatory action and technological innovation are the two primary drivers of the transition, fueled in part by growing recognition of the risks posed by climate change. On the regulatory front, the number of climate laws passed globally has doubled every five years since 1997[iii]. In 2018 for example, China joined the Netherlands, Norway, France, the U.K., and India in banning fossil-fuel-powered vehicle production;[iv] California passed a bill requiring rooftop solar on all homes;[v] and France announced that it will ban oil and gas production by 2040.[vi] Overall, the world has adopted clean energy far faster than experts expected, and countries have moved aggressively in the past few years to reach their targets. This includes the U.S., where despite recent federal legislation, many states, cities, companies, and citizens are taking action on their own to accelerate the transition to a low-carbon economy.

Within technological innovation, price reductions and efficiency improvements in cleaner technologies have accelerated the deployment of carbon efficient technologies to replace existing carbon emitting activities.[vii] Within transportation, for example, due to declining costs and increasing battery storage capacity, the global fleet of electric vehicles is projected to triple in the next two years.[viii] We believe these underlying forces will continue to accelerate the transition to a low-carbon economy into the future.

What are the investment implications of the low-carbon transition?

We believe the transition to a low-carbon economy will create winners and losers across companies, industries, and countries, and ultimately impact long-term investment performance. The transition presents risks and opportunities through four channels[ix]:

	Example impacts on investments
Regulatory	• Carbon taxes and emissions trading schemes (ETS) hurt carbon-intensive companies, while increasing clean energy subsidies and fossil-fuel production bans are shifting investments into cleaner energy.
Technological	• Rapid price reductions and increases in efficiency in renewable energy, electric vehicles, and other technologies provide attractive investments with potential to disrupt traditional business models in oil, gas, and coal.
Physical	• More frequent and severe weather events present costs to insurance companies, such as the record $135bn in damages after Hurricane Harvey, Irma, and Maria.[x]
Reputational	• Changing consumer preferences regarding the low-carbon transition can affect the acceptance of and demand for a company's products and services, impacting financial performance and investor returns.

We believe these shifts are already underway and will continue and accelerate in the future. As prudent fiduciaries and long-term investors, we believe investors should incorporate an understanding of the world's assessment of climate change-related risks and opportunities in their investment processes and portfolios.

Transition Ready Investment Strategy

What is the low-carbon economy Transition Ready strategy?

This strategy is an enhanced passive strategy designed to deliver long-term competitive financial returns relative to traditional benchmarks, and to further align Wespath's investments with the transition to a low-carbon economy. Enhanced passive strategies differ from pure passive strategies in that they modestly overweight or underweight the securities within an index as a way to add long-term value in a risk-controlled manner. The goal of the Transition Ready strategy is to exceed its performance benchmarks by minimizing potential risks and maximizing opportunities associated with the transition to a low-carbon economy, while maintaining a similar risk profile to the benchmarks.

To address the risks and opportunities of the transition, Wespath and BlackRock have developed a new investment framework. The "Transition Readiness" methodology evaluates how well positioned a company is for the low-carbon economy transition, by considering a company's core business involvement in energy production and carbon efficient technology, as well as its capabilities relating to natural resource management in energy, water, and waste. The methodology seeks to reflect a company's ***future*** preparedness for the transition and draws on qualitative and quantitative analysis.

Why is the Transition Ready strategy unique?

Wespath sought a forward-looking strategy which could optimally position its portfolios to benefit from companies supporting an orderly transition to an economy committed to achieving global emission reduction targets. Simultaneously, Wespath aimed to minimize potential systemic risk associated with a low-carbon economy transition, especially given its broad market exposure through its existing public equity assets.

We believe the Transition Ready strategy achieves these goals in three unique ways:

Methodology	Existing strategies attempt to identify either the current "risks" (e.g., low-carbon, divestment) or the "opportunities" (e.g., green revenue, clean technology). This strategy seeks to identify both current and future investment risks and opportunities at a company level through a five pillar Transition Readiness framework and signal construction model.
Data	Most strategies rely on a single source of data. This strategy leverages the most financially material metrics across multiple data providers, identifies the common impulse across providers on key indicators, and integrates proprietary insights from BlackRock. The approach links environmental metrics and data points to financial performance across a broad, investable universe and allows the resulting Transition Ready over/under weights to capture potential mispricing in the market in a new and innovative way.
Fundamental Analysis	The strategy incorporates fundamental investment research on how the transition can and will impact investment performance. These views blend a wide range of academic literature, industry growth projections, climate scenario models, regulatory trends, and more. Resulting over/under weights are validated by analysts using multiple verification tests to ensure financial and environmental outcomes make intuitive sense and further align Wespath's investments with the transition to a low-carbon economy.

How does the Transition Readiness framework over- or under-weight companies relative to the benchmark?

A Transition Readiness signal is generated based on how well positioned companies are to both maximize the opportunities and minimize the potential risks associated with the transition to the low-carbon economy. In general, BlackRock will overweight companies with higher Transition Readiness characteristics and underweight those less transition ready relative to the index, by maximizing the total "Transition Readiness" signal of the portfolio within a total active risk budget relative to a standard performance benchmark.

The key components of assessing the Transition Readiness of a company are its core business involvement and natural resource management. Within these components, five characteristics, or investable pillars provide a direct link to the transition to the low-carbon economy by creating an economic or investment thesis to over/underweight companies based on expected future performance:

Core Business Involvement
Energy production: a company's historical direct emissions, as well as their future potential emissions through fossil fuel reserves ***Carbon-efficient technology***: a company's research and development, current revenue and forward-looking strategy in solutions across renewable energy, energy efficiency, carbon-efficient transportation, green building and sustainable agriculture
Natural Resource Management
Energy management: a company's historical indirect emissions through energy purchased, as well as their strategy to manage future energy consumption ***Water management****:* a company's water efficiency, as well as the projected stress and shortages in its water supply ***Waste management****:* a company's waste production, including hazardous and non-hazardous waste, as well as its strategy to reduce waste production and product-related waste

Once the strategy assesses the company's performance across each of the five pillars, we combine the assessments into a signal for every company. This combination, a company's Transition Readiness, is specific to its industry. That is, the relative weighting of a company's performance across core business and resource management characteristics depends on what elements are fundamentally and financially most relevant for its given industry. The Transition Readiness framework draws from the Sustainability Accounting Standards Board (SASB) sector-specific standards and BlackRock's own analysis to determine exactly what is financially relevant for each industry. For example, health care companies are primarily evaluated relative to their energy, water and waste management, whereas transportation companies are evaluated relative to their GHG emissions and carbon efficient technology strategy and exposure.

What are the benchmarks used for this strategy?

Wespath will apply this strategy to its U.S. and International equity passive portfolios using traditional, non-transition ready benchmarks.

Will this strategy outperform the benchmark?

Over the long run, we believe that firms better-positioned to both maximize the opportunities and minimize the potential risks associated with the transition to the low-carbon economy will outperform their industry peers. We have designed the Transition Ready signal to capture these characteristics.

How will this strategy's environmental characteristics compare to traditional, non-transition ready benchmarks?

The Transition Readiness framework over-weights companies that use natural resources more sustainably, invest in carbon-efficient technologies, and reduce carbon emissions. Currently, the Transition Ready strategy delivers a portfolio that reflects an approximately 50% reduction in carbon emissions intensity and 40% increase in carbon efficient technology exposure relative to the aggregate exposure of the performance benchmarks. This strategy will direct capital to companies best-positioned to facilitate the global transition to a low-carbon economy.

What is the tracking error?

The strategy aims to deliver excess performance within 75-100bps annual tracking error budget to the U.S. and International benchmarks.

Is this a high-turnover strategy?

This is not a high-turnover strategy. We believe that companies positioned to benefit from the transition to a low-carbon global economy are attractive long-term investments. Therefore, the strategy takes a long-term view of these changes and provides a systematic tilt to the portfolio within the specific active risk budget. The portfolio will rebalance as needed to maintain the portfolio within the target risk band. This could include changes from market drift, benchmark changes and index reviews, model updates, cash flows etc. The portfolio will also undertake an annual review to incorporate new research and data, which will be reflected in updated Transition Readiness signals and portfolio optimization.

Does the strategy divest from fossil fuels?

The strategy does not exclude all companies involved in the production or consumption of fossil fuels. It does not invest in "pure-play" thermal coal companies as directed by Wespath's Management of Excessive Sustainability Risk investment guideline, which excludes from investment companies that pose sustainability-related financial risks to its funds.

Outside of the directed exclusions, the Transition Ready strategy will continue to invest in companies involved in the production of fossil fuels, but it seeks to evaluate both the risks and opportunities associated with investing in these companies. On the risk side, the Transition Readiness signal methodology seeks to identify a company's future fossil fuel generation, production efficiency, and exposure to regulation. On the opportunities side, the strategy seeks to identify a company's preparedness to capture new market opportunities in carbon efficient technologies and regulatory tailwinds. These considerations are factored into a total assessment of fossil fuel-related companies focusing on companies most likely to thrive in a world becoming more reliant on cleaner sources of energy.

Why did Wespath select BlackRock to be the partner for this strategy?

Wespath and BlackRock have partnered to build a new and differentiated approach to low-carbon and transition ready investing. Critical to Wespath's search was finding a partner whose approach to long-term sustainable investment, specifically in the area of climate risk and the state of the low-carbon transition, aligned with its **Low-Carbon Investment Belief** (which Wespath's board approved in 2017). BlackRock was also selected due to its ability to leverage its expertise and capacity in quantitative investing and fundamental analysis to create a new low-carbon investment solution.

BlackRock complements Wespath's existing expertise and leadership in sustainable investing specific to climate-related risks and opportunities in the following ways:

1. **Innovative Solutions**: BlackRock manages a range of climate-aware strategies, including the first low-carbon ETF, as well as green bonds, clean energy, and the world's largest global renewable power franchise.
2. **Global Initiatives**: BlackRock holds leadership seats in various climate investing initiatives, including the Green Bond Principles, Climate Bonds Initiative, and the Financial Stability Board's Task Force on Climate-Related Financial Disclosures ("TCFD").
3. **Thought Leadership**: BlackRock Investment Institute has published research on climate change, including its **impact on portfolios**, **how to adapt**, and **clean technology advances**, aligned with Wespath's Climate investment policy and plan.
4. **Firm-wide Data Integration**: Firm-wide, BlackRock has integrated carbon data into the firm's internal systems and made this available to all portfolio managers.
5. **Engagement**: BlackRock has committed to doubling the size of its investment stewardship function over the next two years, with **climate risk** as one of BlackRock's top **5 engagement priorities**.

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