Understanding the advantages of net-zero ETFs

Desjardins specialists detail what advisors need to know as the world moves to a net-zero economy

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As countries move to a net-zero climate goal, investors can capitalize by aligning their portfolios in a way that supports the transition. But with so many investment options, it can be difficult to understand the nuances of each strategy.

Christian Felx, Manager and Head of Responsible Investment at Desjardins Global Asset Management (DGAM), and Pierre-Luc Vachon, Head of Products, Investment Strategies, at DGAM explain the various approaches to responsible investment (RI), and how net-zero ETFs are part of the solution.

How have RI approaches evolved in recent years?

Christian Felx: A growing number of investors are opting for investment solutions that promote sustainable prosperity, with RI assets under management (AUM) growing to more than $3 billion in recent years, according to the Responsible Investment Association[1]. The main reason behind this growth is that we were able to bridge the gap between sustainability and financial performance. We have moved from exclusionary strategies to more sophisticated strategies based on analytical frameworks. We now know that using environmental, social, and governance (ESG) criteria in the investment process helps identify risks and opportunities that are sometimes overlooked by traditional financial analysis.

Can you detail the approaches used in RI ETFs?

CF: First, we need to establish the investment universe. Often, most RI strategies will exclude sectors or companies associated with undesirable activities, such as controversial weapons or tobacco producers.

Second, we assess the ESG performance of issuers with a proprietary scoring methodology. This allows for efficient identification of opportunities and mitigation of risks. For example, an approach that integrates ESG momentum will allow for issuers that have lower or average ESG practices but are set to improve on them in the coming years.

Third, there's portfolio construction, where investment mandates may include an ESG dimension. For example, net-zero trajectory objectives can be added to the investment objective of some strategies without sacrificing the portfolio's expected financial return.

Last, there's shareholder engagement, which is a lever for positive change. The portfolio manager engages in a constructive dialogue with the company, further improving on their understanding of the business, and giving them the opportunity to influence the ESG issuer to adopt sustainable development practices.

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What are the advantages of ETFs with net-zero trajectories?

Pierre-Luc Vachon: A net-zero trajectory aligns with the objective to limit global warming to 1.5 °C, and targets improvement in the portfolio's carbon emissions over time. Previous approaches to decarbonization would simply offer a reduction compared to a benchmark, which wouldn't necessarily improve over time.

How do net-zero ETFs differ from other RI ETFs?

PLV: On the Canadian ETF market, there aren't a lot of strategies targeting carbon emissions, let alone strategies aligning with net-zero objectives. Desjardins' net-zero pathway ETFs target their climate objective while providing broad and diversified equity market exposure.

How is Desjardins' Net-Zero Emissions Pathway ETF focused on RI?

PLV: Our approach is light on exclusions, excluding only companies involved in controversial weapons, tobacco production, thermal coal, or severe controversies. We also use ESG scores derived from our own internal analysis or from third parties.

We're aiming for a portfolio that's well diversified and provides exposure to most sectors while meeting net-zero objectives. For instance, the portfolio construction process enforces geographical and sectorial diversification, and avoids excessive concentration in any single security.

We're offering the strategy in a traditional version and a multifactor version, which adds another step to the process where we allocate the portfolio securities' weights to maximize exposure to factors that have been shown to add value in the long run.

How can advisors and their clients be part of the RI solution?

PLV: Demystify RI and its misconceptions. It's sometimes believed that RI ETFs exclude all companies from the energy sector, while in fact, some strategies will invest in energy companies if they have robust ESG practices or a strategy to improve the ESG integration in their business model, and low carbon emissions relative to their peers.

Another misconception relates to the belief that integrating an RI dimension to the strategy's objective will inevitably impact performance negatively. This topic has been subject to meta-studies[2] where researchers didn't find support to these claims.

Understanding that there are diverse approaches to RI is crucial. Each product and strategy may vary, even if they come from the same issuer. Therefore, it's essential to thoroughly examine the product and gain a clear understanding of what's being offered.

1 Source: 2022 Responsible Investments Trends Report, Responsible Investment Association
2 Sources: G. Friede, T. Busch, and A. Bassen, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies," in *The Journal of Sustainable Finance & Investment* (2015); DWS Group; Hamburg University; and SSRN.

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