A Cheat Sheet on Climate Funds

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Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society, and corporate governance affects and are affected by our economy. I'm Margarita Grabert, your host for this episode.

Today, I want to dive into the world of climate funds because with the increasing frequency of extreme weather events and the efforts of policymakers to slow the pace of climate change, there are a wide range of potential investment upsides and downsides. And one tool to help investors navigate this changing world is climate funds, which have been gaining more traction in the past few years. But what a climate fund is, what it's trying to achieve, and how that differs in private and public markets, well, that's a little more meaty and definitely worth spending some time on. So, thanks for joining me today and let's see where this story takes us.

Extreme heat keeping students in Northern Africa and parts of Asia home from school, or prolonged droughts and then sudden floods playing havoc on crops in France, Germany, and Poland, climate change is manifesting in many different ways. And for companies it can mean supply chain disruptions, labor shortages, and dropping productivity. It also means impacts from policy, from carbon taxes to stranded assets, all the way to new competition from low carbon competitors. And for investors, this can create questions with headaches, where do you put your money or the money of your clients when all of this climate stuff is going down? Well, this is where climate funds come into play.

Funds that either have climate in their name or some kind of climate-related objectives have been around for more than 20 years. This isn't a new financing tool, however, they have really gained momentum in the last few years with some really steep growth. So, to get a better understanding of what this climate fund landscape looks like, and to help our listeners get streetwise on climate funds, I invited my colleague, Rumi Mahmood out of MSCI's London office. To get us started, Rumi explained how to think about these climate funds in the first place.

Rumi Mahmood

So, climate funds are funds that typically include terms related to climate, net-zero, and Paris alignment in their name alongside meeting some general criteria. They typically have climate as a core focus as stated in the investment strategy, or the index construction, or they'll invest in companies with climate solutions-based revenue streams specifically. They also can have a decarbonization strategy or net-zero commitment, or they articulate some type of engagement strategy with a focus on climate issues. So, it's a pretty wide set of fund types that fall under the moniker of climate funds.

Investors are increasingly aware of the risks associated with climate change, and they recognize that some investments will be disadvantaged in the transition to a low carbon economy because of changes in regulation, technology, and consumer behavior among other factors. And at the same time, many investors are seeking to capitalize on opportunities and invest in companies that are developing innovative solutions to mitigate climate change or adapt to it, such as clean energy and electric vehicles and so forth.

And so, there's been a lot of growth in this space in the last few years. So, we wanted to take a look and see what the exposures are for these funds, what are they investing in specifically, and where the flow of capital is going through these funds.

Margarita Grabert

All right. Now we got a little taste of what Rumi and our colleague, Abdulla Zaid were researching and how they defined climate funds. And the name of the fund is essential as this is how the fund markets themselves to investors. This umbrella term of basically any fund with climate in their name will include a whole range of funds, probably some that are pretty different from each other. So, I wanted to ask Rumi to tell me a bit more about what the climate fund landscape looks like.

Rumi Mahmood

So, in this research, we wanted to look at what the underlying exposures were across climate funds. And given the level of growth both in the public and private space, we decided to compare and contrast what these areas were investing in in their climate strategies.

In the public space, we can broadly categorize the universe to four main types, low carbon funds, transition funds, climate solutions, and tech, as well as green bond funds. And all of these are across 1,300 public climate funds globally with assets in excess of $500 billion. And in the public space, we've had a bit more of a period of runway and history with most of these funds having launched in the last five to 10 years.

In the private space, it's a little bit newer. Most of the strategies were launched in the last two to three years, and we have total assets under management of just under $100 billion across 200 private capital funds with climate related names. And as such, their exposure can vary quite a bit more depending on the underlying asset classes they're investing in.

In the public space, for example, information technology and industrials dominated largely through a lot of low carbon ETF's and mutual funds that invest in companies with reduced carbon intensity or carbon footprint relative to a benchmark. While in the private space, we see that there are a lot of infrastructure funds accounting for the largest portion of private climate funds, in fact, almost accounting for nearly half of the cumulative market cap. And as a result, there are different emissions profiles as well because of the different underlying sub-industry exposures between public and private climate funds.

Margarita Grabert

So as Rumi just told us, there is a virtual sweet shop of climate funds out there, and their area of focus can also be pretty different even if they all focus on the topic of climate change. But helpfully, there are a few good rules of thumb. On the one side, there are funds that are looking to help investors mitigate risks that arise from climate change like transition or physical risks. And on the other side, there are funds that are more focused on investing in projects that create positive climate impacts. This could be something like reforestation or even building a solar farm.

But for Rumi, the most important way that these funds differ is not by what they're trying to achieve, but whether they're on the public domain like the green climate fund, or private, something like venture capital with a focus on early-stage companies. So we know a bit more about what these two buckets of climate funds are trying to achieve, but I wanted to know a bit more about where they're putting their money. Let's get back to Rumi on that one.

Rumi Mahmood

So in the public space, we see that information technology and industrials dominated largely through a lot of low carbon ETF's and mutual funds. So these form the largest cohort of climate fund types in the public space, whereas in the private space, we found that infrastructure funds accounted for the largest portion of private climate funds accounting for nearly half the cumulative market cap. That's what leads to differences between public and private climate funds, where in the public space, largely IT exposure and in the private space, it seems that they're going with emissions or through real assets and infrastructure exposure.

Margarita Grabert

So public funds are focusing more on equity in areas like information technology, but there's still a lot of diversity in that area, and the private funds are focusing more on real assets and investing into infrastructure projects in utilities and industrial areas. Rumi didn't get into the nitty-gritty of all his research, but I took the liberty of diving into the numbers myself, and there's been significant growth in both areas of climate funds. So I went back to him for more details on the fund inflows and outflows, and how fund creation has changed in the last few years.

Rumi Mahmood

So, in the public space, we've witnessed climate transition funds having grown the most in the past couple of years to become the largest climate fund category with assets in excess of $200 billion up 25% in the last year. So just to clarify, transition funds select or tilt towards companies that consider climate change in their business strategy, and they tend to invest in a mix of companies, those that better align with the transition and those that provide climate solutions. And also included in this category are funds that track EU Paris-aligned benchmarks. And so these funds have been the most rapidly growing segment in the public space.

In the private space, on the other hand, most private climate funds were actually launched in the last two to three years. In fact, private climate funds that were launched between 2020 and the end of 2023, outweighed in market capitalization, all the previous private climate funds launched in the previous decade combined. So it's been a relatively new growth segment in the private space, and a lot of it has been driven by the Inflation Reduction Act, which has acted as a tailwind in the private climate fund space.

Margarita Grabert

All right. It seems like Rumi's research is showing that climate funds are focusing more on transition, the target companies that might be aligned to the Paris Agreement, or that are working in climate solutions. Typically, these climate funds are targeting more long-term objectives and this is why equity financing has been more at the forefront. The investors of such climate funds are looking to achieve long-term climate related goals as the world is working towards net-zero. So with such long-term perspectives, you might be curious about how these funds have actually performed over the more short-term horizons.

Rumi Mahmood

So in terms of performance, it's a bit of a mixed picture for public climate funds. And this is largely driven by the fact that there's a lot of diversity in fund types in this space. So a lot can depend on the prevailing macroeconomic conditions. Funds that, for example, say, have more exposure to energy materials and utilities will obviously perform better in a cycle where these sectors are performing better versus funds that, say, apply exclusions to them because they want to be lower carbon emissions intensity right now.

So it's been a bit of a mixed picture, and a lot depends on the underlying exposures and the portfolio construction of these funds. And in the private space, it's actually too early to tell because a lot of these funds will exist for five, 10 years, and we can only truly tell what the performance will be upon the exit of these funds.

Margarita Grabert

So it might take a little more time before we can say something more definitive about fund performance, at least in the private space. And public funds so far are largely aligned to how their respective sectors are doing in the wider economy. But before I let Rumi off the hook, I wanted him to give us a look at the future, at what gaps currently exist and how climate funds are reporting, or what might be on the wish list of the climate focus investor, but other stakeholders too.

Rumi Mahmood

So as mentioned, there's a lot of growth and interest in climate funds both in the public and private space. Now, the benefit of the public space is of course, that a lot of companies disclose their scope 1, 2, and to an extent, scope 3 emissions, which investors can take a look at, track, analyze, and assess the performance of the companies and the funds. Whereas in the private space, of course, disclosure is a lot more patchy and it's not mandatory. So we can apply estimations of course, but we don't really know what the exact scope 1, 2, and 3 emissions are in the private space.

So transparency into climate funds in the private space over the long term is something that would help investors evaluate the efficacy of these strategies as well as their impact in reducing both real world and portfolio-financed emissions. And as well as understanding the underlying holdings of climate funds, disclosures may be necessary across different sustainability dimensions.

There are a number of new market-based initiatives that have emerged to provide climate transparency that may ultimately help channel more capital in this space. One example of this is the ESG Integrated Disclosure Project that could encourage more consistent private market disclosure and ultimately facilitate a fairer comparison between various strategies for climate investment across the public and private space.

Margarita Grabert

I feel like we've come pretty far on our journey to be streetwise about the wild world of climate funds. As Rumi puts it, it is pretty clear that these funds are looking to either invest in some emerging climate solutions or sometimes simply just trying to avoid the adverse effects of climate change, but that doesn't really narrow down your investment menu. Private climate funds tend to be more focused on financing infrastructure with a focus on renewable electricity. But the public markets are leaning more towards exploring low carbon solutions in areas like information technology, industrials, and healthcare.

So maybe that's a helpful jumping off point, but these are very early days. What might be next on the mind of investors and other stakeholders as well is seeing more disclosures around where these funds are putting their money specifically and what they're trying to achieve in the long term.

That's it for this week. I want to say a big thank you to Rumi for joining me today, and a big thanks to you for listening. If you enjoyed our content, feel free to give us a like or some stars or even subscribe on whichever platform you're listening from so that you can hear me or one of our other regulars again next week. Thanks again and talk to you soon.

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