Climate Transition: Burning Questions for Credit Strategies

Transitioning the global economy to net-zero emissions presents a significant challenge, but it also offers opportunity—in energy, utilities, and beyond.

This was the topic of a special panel discussion at Allspring Global Investments' recent symposium. Responding to questions from institutional investors and the media, Henrietta Pacquement, Jens Vanbrabant, and Catherine McLaughlin shared Allspring's views on how fixed income portfolios can effectively decarbonize while enabling the transition to a net-zero economy. At the heart of this discussion was Allspring's focus on finding solutions that reflect the realities of a changing world.

This summary of the recent discussion sheds light on the investment rationale for decarbonization, which can help investors better understand how an investment solution can achieve its objectives.

Why allocate to fixed income for strategies that seek decarbonization?

The transition to a net-zero economy calls for significant investment capital across most industries, along with a dedicated strategy focused on a path to net-zero emissions. For example, the investment capital required in the energy sector to avoid an increase in global temperatures by 2 degrees Celsius is estimated at US$2.4 trillion annually through 2050 (Figure 1). This creates a long-term opportunity for fixed income investors to channel money to projects on both the supply side (such as renewable energy) and the demand side (smart metering and grid improvement initiatives, for example).

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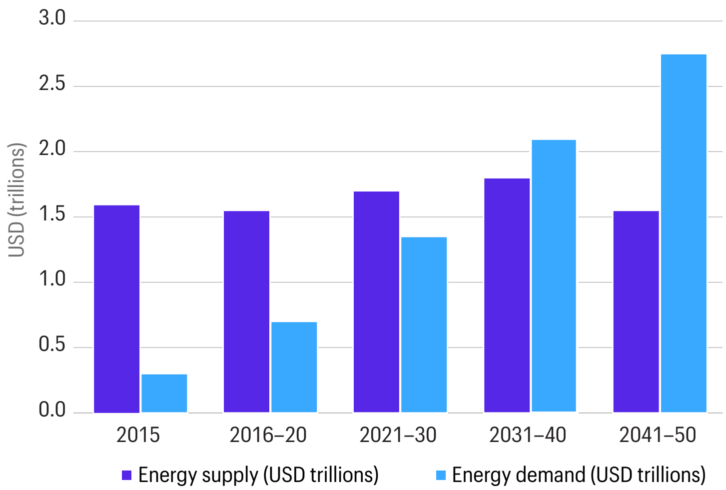
FIGURE 1. AVERAGE ANNUAL GLOBAL ENERGY SUPPLY AND DEMAND SIDE INVESTMENTS IN 66% 2°C scenario



Source: Executive Summary/Chapter [1/4] of Perspectives for the energy transition: Investment needs for a low-carbon energy system ©OECD/IEA and IRENA March 2017

Historically, equity markets were ahead of the curve for sustainable investing, but fixed income markets have been catching up quickly. This is due, in part, to the quality and uniformity of environmental, social, and governance data broadly and climate-related data specifically for fixed income securities, which has improved tremendously over the past three years.

Better data availability has allowed asset managers to improve in-house qualitative and quantitative expertise. Allspring's investment teams are now able to analyze carbon emissions and carbon intensity data over a period of time to inform proprietary views on whether a company is actually achieving the sustainability claims that they make.

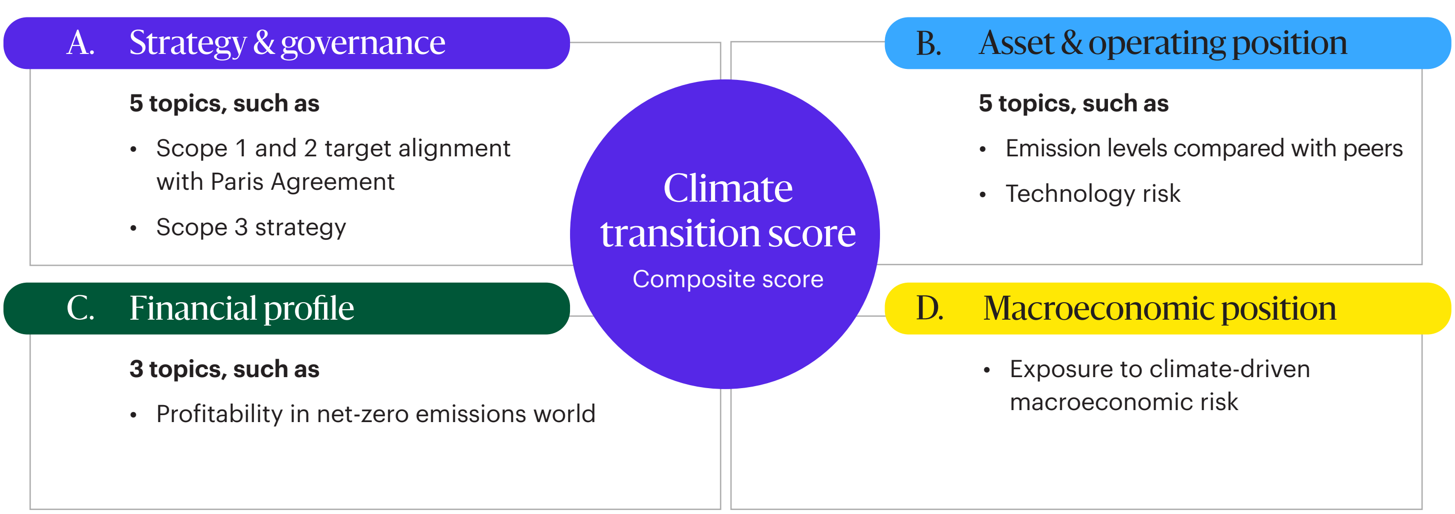
Companies are increasingly compelled to respond to investor demands to provide transparency into their efforts to address climate change as well as their results. They are also realizing that climate change issues influence their entire capital structure, not just equities. This paves the way for broader and deeper engagement efforts, which help inform investors and potentially influence corporate operations.

How is the goal of decarbonizing companies translated to decarbonizing portfolios?

Some investment funds and indexes simply screen out carbon producers. While this method is straightforward to implement, it may not lead to the desired financial or climate goals. It may also preclude investments in firms that are currently emitting substantial amounts but are poised to outperform in both decarbonization and financial terms. Allspring seeks exactly this type of firm: one that can lead decarbonization of the economy as well as value creation.

To do this, our research and investment teams have developed a proprietary Climate Transition Framework (Figure 2).

FIGURE 2. ALLSPRING'S CLIMATE TRANSITION FRAMEWORK



Allspring designed this framework to assess how climate change affects company fundamentals from various angles:

- **Strategy and governance:** How strong is the firm's climate strategy? Does it convincingly address risks and growth opportunities? Are governance systems in place that can facilitate the strategy's implementation?
- **Asset and operating position:** How cost-competitive will the firm's physical asset base and operations be as new technologies, regulations, and taxes appear?
- **Financial profile:** Can the firm maintain sufficient financial flexibility to execute this transformation? What does its profitability look like in a net-zero world? How might any climate-related liabilities affect this?
- **Macroeconomic position:** How will geopolitical and macroeconomic risks and opportunities affect the company as it transitions?

We score each of these four components and derive a climate transition score for each security, which helps characterize how well positioned a company is to contribute to decarbonization and to financially outperform. Firms with a score of four are considered exceptionally well positioned, a score of three indicates relatively well positioned, a score of two is neutral, and firms that score one appear vulnerable.

This climate analysis is fully integrated with the credit research performed by Allspring's Global Fixed Income Research team that includes traditional financial metrics (such as yield, duration, beta, volatility, etc.) for each security, issuer, and sector.

Green bonds or traditional bonds: Which are more likely to effect change?

Green bonds (which are issued specifically to fund projects that are expected to favorably affect the environment) are more easily identified as candidates for decarbonizing a portfolio, but they represent less than 5% of the global bond market.

The terminology suggests that green bonds present the best opportunity to achieve climate goals. However, the small size of the market together with the limited number of issuers using these securities means that their overall impact continues to be modest. We use a number of criteria to assess the value of green bonds, including consistency with the issuer's climate position overall to ensure we achieve our objectives and whether it has adequate performance potential. Green bonds are one of many vehicles Allspring uses to express our fundamental and investment credit views.

Traditional bonds, on the other hand, present asset managers with the opportunity to influence management actions by engaging to effect change. These bonds also have the potential to deliver even greater decarbonizing benefits than green bonds, depending on the issuer's activities. Allspring invests across the bond spectrum, recognizing that all types of investments offer opportunity to achieve both financial goals (investment returns) and nonfinancial goals (decarbonization) for our clients.

A case in point is Russia's invasion of Ukraine, which illustrated global oil and natural gas dependency and the need for fossil fuels for some time to come. Practically speaking, that means divestment of bonds in the energy sector is not always the right answer for a fixed income portfolio. Allspring's investment process includes assessing relative value to balance climate goals with key financial objectives for risk, return, and diversification.

Where does engagement fit in?

Engagement is an essential part of transitioning to net zero. Over the past 5 years, Allspring has significantly increased our engagement efforts; last year alone, 9 out of 10 meetings with firms included some discussion of climate change. Engagement is aligned along themes that affect both our fixed income and equity teams across the firm in an effort to leverage our diverse investment platform as much as possible.

Allspring uses a two-track approach, with individual *and* collaborative avenues for engagement, depending on the industry, type of interaction, and other factors. Collaborative engagement efforts—including work with the Climate Action 100+ group—can be especially helpful in building consensus around expectations for firms. At other times, a focused approach may be more effective, such as our engagement program with the airline industry. In this case, we coordinated our efforts to target the whole sector, as climate topics apply generally across the industry.

We see engagement as a two-way street. Companies increasingly come to Allspring for guidance on creating new bond issues, focusing on certain key performance indicators, dealing with operational initiatives, or other matters. We aim to foster a collaborative relationship with firms that have the intention to improve their impact but lack some area of expertise.

A final word

Decarbonizing the economy is more like a marathon than a sprint, measured not at a single point in time but along the path to net zero by 2050 (Figure 3).

FIGURE 3. KEY MILESTONES ON THE PATH TO NET ZERO

Key milestones in the pathway to net zero

	2025	2030	2035	2040	2050
Buildings	No new sales of fossil fuel boilers	All new buildings are zero-carbon-ready	Most applicances and cooling systems sold are best in class	50% of existing buildings retrofitted to zero-carbon-ready levels	More than 85% of buildings zero-carbon-ready
Transport		60% of global car sales are electric	50% of heavy truck sales are electric	50% of fuels used in aviation are low-emissions	
Industry		Most new clean technologies in heavy industry demonstrated at scale	All industrial electric motor sales are best in class	Around 90% of exisiting capacity in heavy industries reaches end of investment cycle	More than 90% of heavy industrial production is low-emissions
Electricity and heat		Phase-out of unabated coal in advanced economies	Overall net-zero emissions electricity in advanced economies	Net-zero emissions electricity globally	Almost 70% of electricity generation globally from solar photovoltaic and wind

Source: IEA, Net Zero by 2050

Allspring sees attractive alpha opportunities in fundamental climate-transition credit investing, relying on forward-looking insights for an informational edge that will reward our clients over the long term.

Fixed income already plays a critical role in helping decarbonize the world and continues to represent a massive opportunity for our clients to invest in future transition winners and manage the impact of climate risk on their portfolio.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

Contact details

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