Quick Take: Does decarbonization require betting against oil?

April 2022

Rising oil prices exposed dormant risk in decarbonization strategies

- The conventional approach to portfolio decarbonization divests from fossil fuel-heavy industries, typically inducing negative active bets on oil prices and energy stocks.
- In recent years, such positioning looked benign or even appealing to many investors as the energy sector's benchmark weight shrank (top chart) as 1) technology stocks surged, and 2) the emergence of shale supply, COVID, and the Saudi-Russia oil price war put downward pressure on crude.
- But risks associated with broad exclusions resurfaced as oil prices first rose in late 2021 and then spiked when Russia invaded Ukraine.

Investors have alternatives

- For sustainable investors who are concerned about risks of rigid negative oil price exposure, there are alternatives. Instead of broad divestment, constraining the portfolio's total carbon exposure provides greater flexibility to decarbonize through stock selection or sector reallocation, even allowing for positive energy-related positioning when prospects look favorable.
- To illustrate, the bottom chart compares the active oil exposure of an Emerging Market "carbon constrained" strategy, which restricts portfolio carbon exposure[1] and only selectively divests high emitters, to a "fossil fuel free" strategy that employs similar carbon exposure restrictions but also broadly divests companies that own fossil fuel reserves. As the energy sector forecast improved in 2021, the carbon constrained strategy's active oil beta rose and became positive. In contrast, imposing broad divestment meant that the fossil fuel free strategy maintained a negative oil price beta. (Both strategies achieved similar reductions in carbon exposure.)
- The example highlights that investors have alternatives in constructing sustainable strategies. Nuanced portfolio construction can help to balance responsible investing and financial objectives.

1. Scope 1 & 2 weighted emissions and carbon intensity (WACI).

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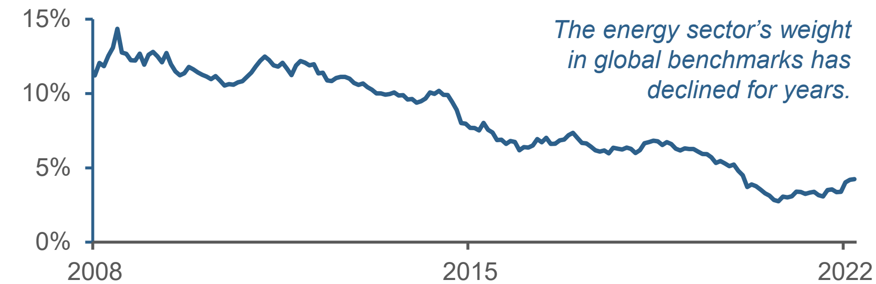
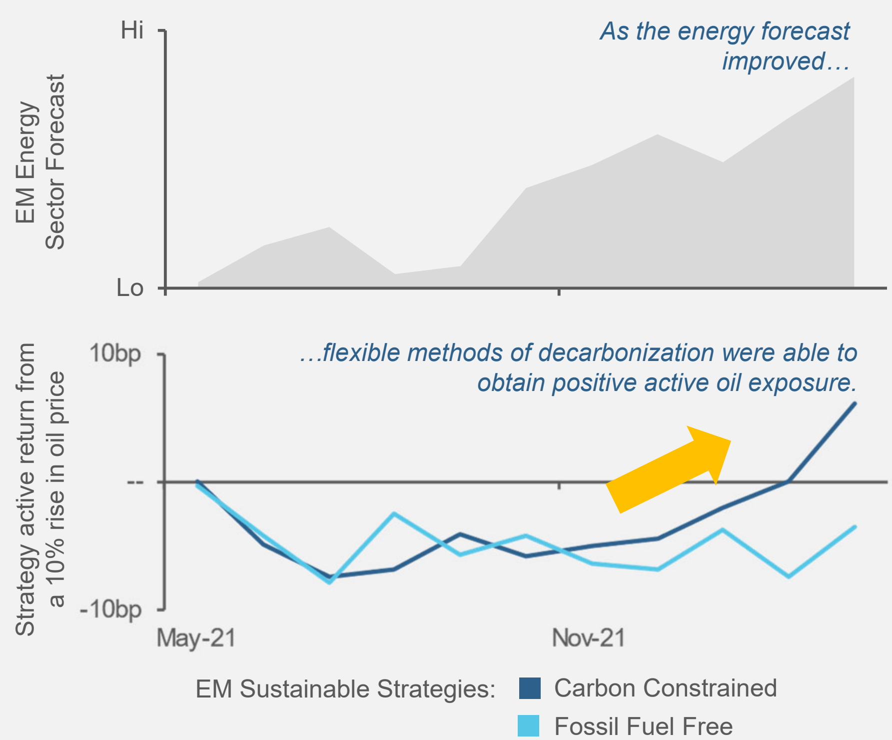
Shrinkage of the Energy Sector: Weight in MSCI ACWI Index



Source: Acadian based on data from MSCI. For illustrative purposes only. MSCI data: Copyright MSCI 2022, All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. For illustrative purposes only.

Oil Price Forecast and Active Oil Exposures



Source: Acadian. Carbon Constrained strategy employs various portfolio constraints on carbon exposures and selectively divests high carbon emitters, while the Fossil Fuel Free strategy employs similar constraints and also broadly divests companies that own fossil fuel reserves. The information provided is for illustrative purposes only based on proprietary models. Investors have the opportunity for losses as well as profits. Past performance is not indicative of future results.

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