<u>**Passive Investment: Exposing the investors and the earth to climate change risk**</u>

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As active equity investments have been struggling to beat their respective benchmarks, the popularity of low-cost passive investment strategy has surged in recent years. The size of the passively managed funds expanded rapidly and now constitutes a considerable portion of the global investment fund universe. The Asset Under Management (AUM) by the passive funds crossed $10 trillion in 2019[i] – more than 20% of aggregate investment fund assets.

The theoretical underpinning of passive investment strategy emanated from the notion of the efficient market - securities prices are fair and incorporate all the available information at all the time. Empirical evidence suggests that most active equity funds have failed to outperform the market consistenly. This implies that an active investment strategy cannot always beat the market. Hence, there are additional benefits of passive management – saving fees incurred on active investment management with the expectation of generating return more than the benchmark return.

Failure of passive investment strategy to serve the investors– reliance on market pricing

In practice, the financial market's horizon of pricing securities is short to medium term – one day to a maximum of ten years. So, they focus on the company's action plan over the short to medium term. However, the impact of climate change on the prospects of the company is mostly long term in nature, which is neglected by both the investors and decision-makers at corporates. This is a classic case of market failure since the market is not incorporating both the physical and transition risk emanating from climate change. This market failure is what Mark Carney (2015)[ii] referred to as "the tragedy of the horizon."

The market indexes – most of the passive investment fund mimics – consists of industries/companies that are exposed to climate change risk given that these companies are carbon and pollution intensive, i.e., coal, oil, and gas producers, electric utilities, fossil fuel-dependent manufacturing, and transportation industries. Besides, there are other companies which may not be emitting carbon and generating pollution - directly or indirectly - but may face acute and chronic risk. Ironically, stock prices of these companies do not reflect these risks as the market does mot them as material risks, which are long term and never occurred historically. The companies' market capitalization of these companies is still high and has not changed significantly over the years. Moreover, these companies' weightage in the indexes is also very high. Hence, the over-reliance on market efficiency in developing a passive investment strategy is making the investment vulnerable to climate change.

The passive investment strategy is indifferent to climate change and making the economy vulnerable to climate change

Passive investment strategy mimics as specified indices, which constitute companies/sectors which are carbon and / or pollution intensive in nature. Since many large asset managers (Vanguard, BlackRock, State Street, etc.) follows this investment strategy, a large amount of capital flows into these companies/sector, consequently, increase the value of the companies in the stock market. An increase in the stock prices of the companies gives enough comfort to banks and other debt financers and, in effect, making the economy more carbon-intensive. Unfortunately, these large asset managers, having substantial voting power, are not taking adequate measures; they are neither exerting pressure on these companies to decarbonize or off-loading their positions from these companies. Even if the ultimate beneficiaries of the funds want to make their assets less carbon-intensive, they are small and diversified (no real group) to exert pressure on the asset managers. Even if the asset manager wants to make the portfolio less carbon-intensive, they don't have any power to select stocks, which can not mimic the index – issue of tracking error, which often irks investors. So, the passive investment strategy keeps on investing in carbon-intensive industries.

How to make a passive investment is a win-win situation for investors and the climate

While it is an opportunity for investors to exploit the mispricing of securities since they do not reflect the real risk (and opportunity) related to climate change, but there is a possibility of drifting away from the benchmark index. Hence, there are multiple ways to achieve the twin, ofnten considered to be competitive (but can be competitive) objectives – following passive investment strategy and making the portfolio climate change resilient. Asset managers are increasingly engaging with companies to make these companies' businesses less carbon-intensive through stewardship, constant engagement, and proxy voting. Some asset managers are creating carbon-neutral and or less-carbon intensive rule-based portfolios, which can match with respective benchmarks or as per the client's specific requirements. These portfolio managers have limited discretion to select any particular security or tilt the fund towards specific sector/s since the portfolio are rule-based. These portfolios not only match with the conditions of passive management strategy but also capitalize on the investment opportunities that arise from the transition to a low-carbon economy. Moreover, these portfolios can hedge against the top risk the World is going to face over the coming decade – climate change (WEF, 2020)[iii].

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[i] https://www.ft.com/content/a7e20d96-318c-11ea-9703-eea0cae3f0de

[ii] https://www.bis.org/review/r151009a.pdf

[iii] https://www.weforum.org/agenda/2020/01/top-global-risks-report-climate-change-cyberattacks-economic-political/