For today's investor

WHITEPAPER

Long carbon credit

Exploring unconventional sources of alpha

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Jennie Byun, Ahmed Behdenna and Thomas Dillon explain the rationale behind a long carbon strategy being implemented in the AIMS Target Return portfolio.

Key points

- We believe prices for carbon emissions will continue to grow as government policies incentivise the reduction of greenhouse gas emissions and efforts to meet the ambitions of the Paris Agreement.
- The long carbon strategy is another example of how we are using our flexible, unconstrained approach to diversify our return stream into strategies that we believe offer better risk-reward profiles than traditional asset classes.
- The idea utilises insights drawn from our dedicated ESG team.

Background

As highlighted in the recent paper "AIMS Target Return: Widening the Opportunistic Set", in a world of record-breaking, liquidity fuelled valuations across most traditional markets, it helps to have the means to tap into investment ideas where the risk-return profile is more favourably skewed to the upside. We view the carbon emissions market as one such area of opportunity, and a strategy to tap into this has recently been introduced into the AIMS Target Return portfolio.

The European carbon emissions market has been around for more than 15 years; however, activity (and along with it, prices) was relatively muted until fairly recently, as seen in Figure 1. With kinks in the allowance system having been ironed out and the European Union increasingly serious about decarbonising the region's economy, the expectation is for carbon prices to move significantly higher. This is now one of the key policy tools to incentivise companies and help the EU meet its 2030 climate target of a 55 per cent fall in emissions from 1990 levels.

Figure 1. **European Union Carbon Emission Allowance price**

Source: Bloomberg, ICE

Strategy

The strategy that has been implemented in the AIMS Target Return portfolio is to go long the EU allowance (EUA) futures market. Each EUA is an entitlement to emit one tonne of carbon dioxide equivalent gas, as defined in the ICE Futures Europe framework.

Rationale

There is strong political will across the EU to reduce greenhouse gas emissions, with Europe at the forefront of global efforts to meet the targets set out in the 2015 Paris Agreement[1]. The EU's emissions-trading scheme (ETS), the largest in the world, works on a compulsory cap-and-trade principle and is the main mechanism by which companies within the power, manufacturing and aviation sectors can offset their emissions. As of 2020, the scheme covered approximately

1. 'Climate change – updating the EU emissions trading system (ETS)', European Commission, October 29, 2020.

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40-45 per cent of the region's total emissions, and it is expected that the EU will expand its scope of mandatory participants in April 2022.

Price signal is widely considered the best policy tool to change behaviour in a way that is both coordinated and decentralised. As demonstrated in Figure 1, prices have risen since Q4 2020, now trading at €43 per metric tonne, but there looks to be significantly more room to go as current prices may not be deemed high enough to materially change corporate behaviour.

Some estimates see at least a price of €100 per metric tonne before global emissions reduce by an amount that comes close to meeting current climate targets[2]. In that regard, the EU declared its objective to gradually reduce its annual EUA cap, with the intended effect of raising the cost of emissions-intensive activity. This should push investments into green technology and help the EU achieve its 2030 targets.

Downside risks

Political intervention is both a driver and a downside risk for this strategy and monitoring these dynamics will be a key focus. If the global fight against climate change remains a key priority, we have conviction the carbon trading market will continue to grow and evolve, even expanding in scope to include sectors such as heat, transport and shipping.

Nevertheless, while the goal is to drive carbon prices higher to curb emissions activ§ity, the scenario also exists for the European Commission to intervene and temper any erratic or extended swings in the market, as well as rein in excessive speculative activity as part of this year's upcoming (and any future) ETS reform. The concern is less the absolute price level - the objective is for higher prices - but the volatility of the price movements that will determine whether intervention is deemed necessary and is another factor we will monitor closely.

2. 'How the European Union could achieve net-zero emissions at net-zero cost', McKinsey & Company, December 3, 2020.

Key Risks

The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested. Convertible bonds can earn less income than comparable debt securities. They can also earn less growth than comparable equity securities and carry a high level of risk. Bond values are affected by changes in interest rates and the bond issuer's creditworthiness. Bonds that offer the potential for a higher income typically have a greater risk of default. Investments can be made in derivatives, which can be complex and highly volatile. Derivatives may not perform as expected, meaning significant losses may be incurred.

Some investments could be hard to value or to sell at a desired time, or at a price considered to be fair (especially in large quantities), and as a result their prices can be volatile.

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