Making changes

Henry Odogwu reveals why climate change also matters for government bond investing

The global sovereign debt market is one of the largest asset classes in the world, and yet lags other asset classes when it comes to integrating climate change issues into investment processes. Sovereign debt investors are still exposed to a range of climate change risks that are not well understood or incorporated into the investment process. Part of the challenge has been the lack of sustainable investment products and viable climate data.

Climate change risk has long been a consideration for publicly-traded stocks. Today, investors can choose from a broad selection of equity products designed to avoid companies with high exposure to climate change risk: when it comes to government bonds, market participants have largely overlooked the potential impacts of climate risk.

Governments are exposed to both transition risk and physical risk related to climate change, and these risks are material and growing. Transition risk relates to the costs associated with countries transitioning to a greener economy. For example, growing concern over climate change – and the resultant increased regulation – has many countries developing plans to reduce carbon emissions. The UN estimates that such an undertaking would require investing about $1 trillion per year over 30 years, with this expenditure largely financed by governments.

Transition and physical risks have the potential to materially impact government debt, which is why it's important to consider climate risk alongside traditional risk measures when investing in sovereign bonds. To this end, FTSE Russell has developed a solution to serve as a sustainable alternative for passive government bond investors, the FTSE Climate Risk-Adjusted World Government Bond Index (Climate WGBI).

The Climate WGBI methodology conducts quantitative climate risk assessments across transition risk, physical risk and a country's resilience. The index scores countries across each of the pillars and a single combined score is derived for each country. The scores are then used to reweight the country's exposure in the index to provide higher exposures to countries that are better prepared for climate change risks and lower exposures to countries that are more threatened by climate change risks.

By incorporating these three climate risk pillars and weighting constituents accordingly, the Climate WGBI offers a solution for the growing number of investors who are recognising that climate risk considerations aren't just for equities – they also matter when investing in government bonds.

Transition risk	The impact on the economy from the required efforts to mitigate climate risk as measured by modelled emissions needed to meet 2 degree alignment
Physical risk	The climate related risk to the country and its economy from the physical effects of climate change
Resilience	A country's preparedness and actions to cope with climate risk

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