

Can You Protect the Environment and Your Yield?

By Global Client Strategy - Insurance

Key takeaways:

- + As disclosure requirements increase, insurance company investors should understand their portfolio's carbon profile and the key drivers of carbon intensity.
- + About 20% of the typical property and casualty insurance company's investment portfolio is responsible for 80% of its total carbon intensity.
- + Our analysis indicates carbon intensity can be reduced without harming portfolio yield.



Introduction

Fears of climate change are everywhere in the media, from the coverage of wildfires in Maui and California to more pedestrian complaints about shifting weather patterns that inconvenience our daily lives.

Pocketbook issues are likely to magnify and focus this attention. For example, few consumers have been directly affected by a wildfire or hurricane, but most buy insurance to protect against these perils, which have been exacerbated by climate change. Property and casualty (P&C) insurers are in the unenviable position of having to pass the expected costs of climate change through to consumers today in the form of higher premiums.

Costs have continued to rise due to residential expansion into more risk-exposed regions, more frequent and severe weather events, and higher reinsurance costs. Moreover, repair costs have increased due to inflation. Availability of coverage can also be limited by regulatory mechanisms designed to protect the public. Premiums have not increased as fast as

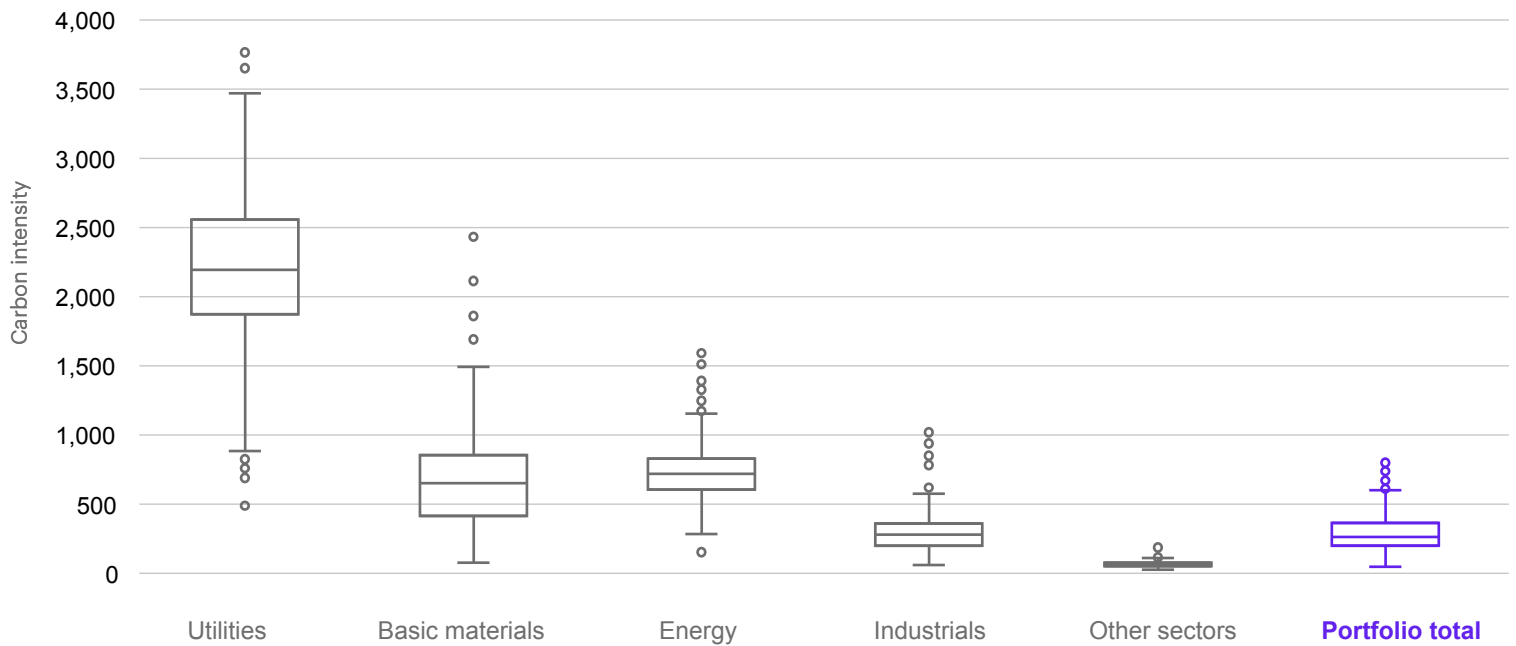
claims costs, which is pressuring financial results and leading to well-publicized withdrawals from several large markets, including Florida and California. Regulators such as the National Association of Insurance Commissioners (NAIC) have responded by making climate a top concern, requiring insurers to disclose more about climate risk and resilience.

This confluence of events will keep insurers in the spotlight when it comes to balancing the coverages they offer and the investments they make to support them. In this evolving environment, we think portfolio owners should understand the drivers of carbon intensity in their investment portfolios.

In this paper, we look at the role that carbon intensity plays in bond portfolios across the P&C industry. Two findings stand out from our analysis. The first is that P&C companies have a wide range of carbon exposures within high-emitting sectors, such as utilities, basic materials, and energy. Second, lower carbon-intensive investments do not necessarily imply lower yields. This suggests that a greater focus on carbon intensity need not come at the expense of investment goals.



FIGURE 1: CARBON INTENSITY OF P&C INVESTMENT PORTFOLIOS BY BOND SECTOR



Sources: S&P Global Market Intelligence, NAIC, and Bloomberg. Allspring calculations. Data presented as of 31-Dec-22.

What drives greenhouse gas emissions in a bond portfolio?

There are several ways to measure the carbon profile of bond issuers. In this article, we use carbon intensity,^{1,2} which normalizes carbon emissions by the bond issuer’s revenue. This gauges the efficiency of the portfolio rather than the absolute amount of greenhouse gas emissions. Figure 1 shows the carbon intensity by sector for the bond portfolios of 307 companies in our P&C company database, each with public bond holdings over \$50 million. The chart shows the 25th-percentile, median, and 75th-percentile ranges in the boxed area for each sector.

It may be a surprise to learn that insurers have a wide range of carbon exposures within high-emitting sectors. Utilities are by far the highest-emitting sector, followed by energy and basic materials. The median utilities allocation has a carbon intensity that is about six times the portfolio average, while basic materials and energy are about two times.

Looking deeper, the median P&C company in this sample has a 6.6% allocation to utilities, 1.8% to basic materials, 4.9% to energy, and 7.6% to industrials. These high-emitting sectors together represent only about 22% of a typical company’s allocation but contribute over 80% of the portfolio’s carbon intensity. “Other” sectors, such as financials, technology, consumer cyclical and non-cyclical, and communications, make

up 78% of the median company’s allocation yet have low carbon intensity. This suggests that making smarter investments within high-emitting sectors can go a long way toward reducing overall bond portfolio carbon intensity.

Does carbon intensity influence portfolio yield?

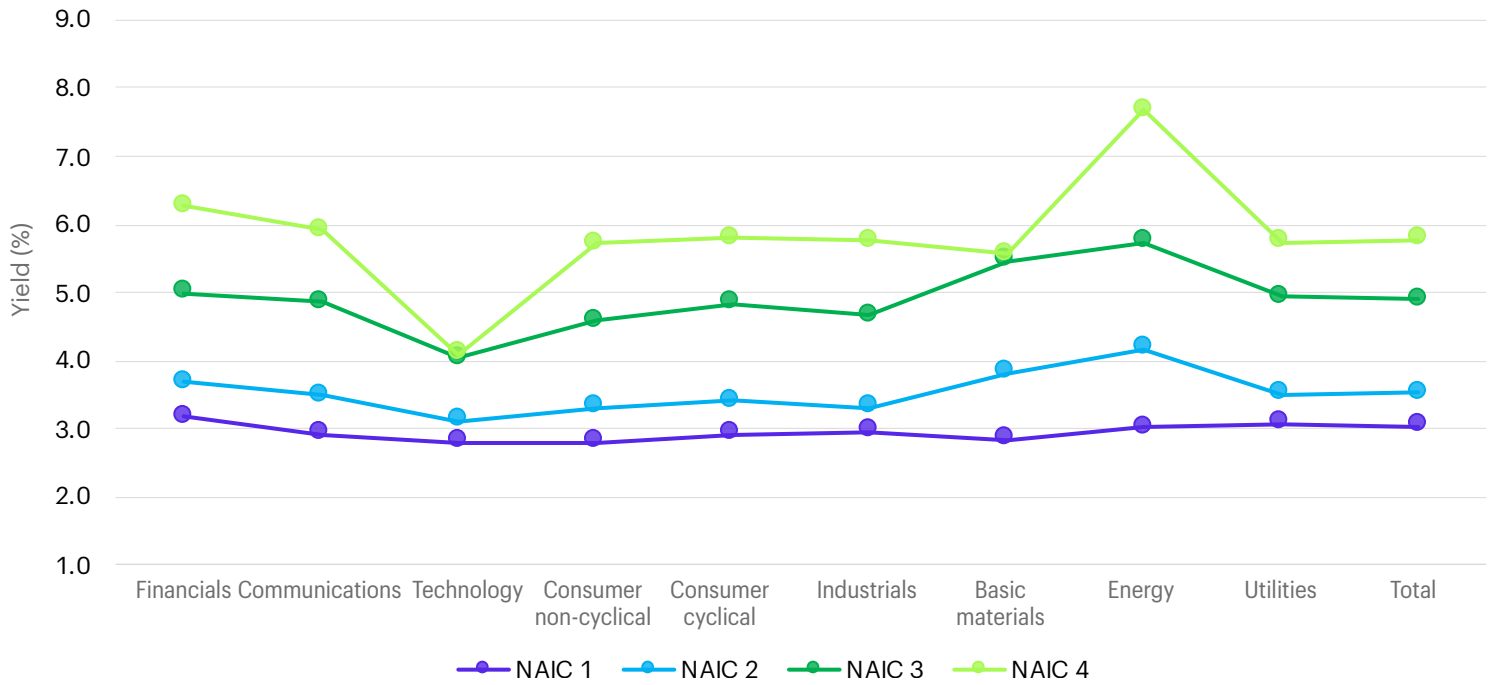
For companies in the P&C universe, we have found very little relationship between bond portfolio carbon intensity and book yield.

To illustrate this, Figure 2 shows the book yield for the P&C universe’s year-end 2022 holdings when split by sector and NAIC quality. From left to right, the sectors are ordered from the lowest carbon intensity to the highest. It is likely no surprise that lower-quality bonds tend to have higher yields.

Yields vary by sector, too. For NAIC 1 (AAA–A quality) bonds, the highest yields come from the financials sector while energy merely generates average yields. But for lower-quality tiers, energy has much higher yields than the other sectors. Utilities tend to be within a few basis points of the portfolio average across quality grades. Purchases made in 2022 show the same general pattern as prior-year purchases, although recent purchases show more variation among sector/quality buckets.



FIGURE 2: P&C UNIVERSE BOOK YIELD BY SECTOR AND NAIC QUALITY



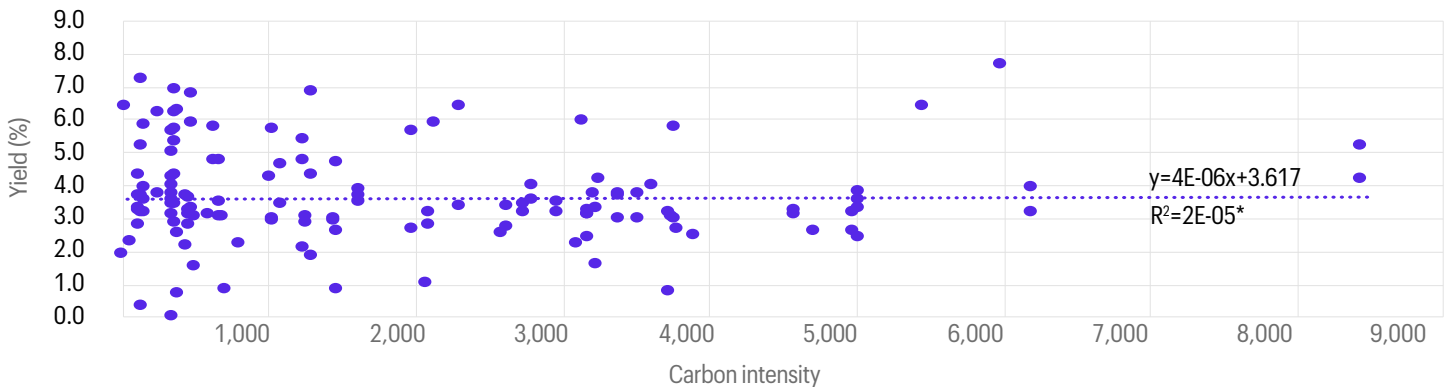
Sources: S&P Global Market Intelligence, NAIC, and Bloomberg. Allspring calculations. From left to right, the sectors are ordered from the lowest carbon intensity to the highest. Data presented as of 31-Dec-22.

It's well understood that quality is a key driver of yields. Less widely understood is that carbon intensity is often a very weak driver of yields generated even within high-emitting sectors. For example, in Figure 3, we plot the relationship between the carbon intensity of individual issuers within the utilities sector and the book yield they generate. The book yield shown is the weighted average across our sample of P&C companies. While this book yield statistic is made up of purchases that have

occurred over time by insurance companies, there appears to be little evidence of a yield pickup for higher carbon issuers. Similar patterns play out in other sectors.

The upshot of this analysis is that improving the carbon intensity of a portfolio does not need to harm the portfolio's yield. Improved security selection within high-emitting sectors can go a long way toward reducing unwanted carbon intensity while sustaining the yields required to meet P&C company investment goals.

FIGURE 3: P&C UNIVERSE UTILITY ISSUER CARBON INTENSITY VERSUS YIELD



Sources: S&P Global Market Intelligence, NAIC, and Bloomberg. Allspring calculations. *The dotted line represents the slope of the regression. The slope is +0.000004x and the y intercept is +3.617. The R2 of the regression is +0.00002, which indicates that carbon intensity explains significantly less than 1% of the variance of yield. Data presented as of 31-Dec-22.

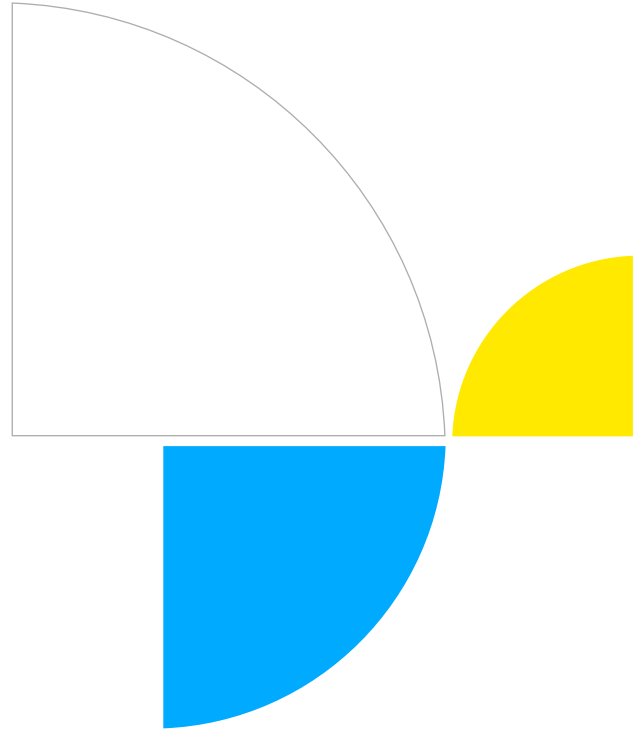


Conclusion

There are many nuances in the ways that P&C insurers invest in fixed income markets. For example, they tend to own higher-quality, shorter average life financials along with slightly lower-quality, longer-maturity bonds in sectors with hard assets, such as energy and utilities. This is a logical way to diversify and manage portfolio maturity, and it need not be abandoned by reducing carbon intensity.

Insurance companies that are beginning to think about the carbon profile of their investment portfolios might benefit from a simple analysis of the carbon intensity of their existing investments relative to a relevant corporate bond index and peers. This allows them to understand where they stand at present. We are specialists in this type of engagement, and this is only one of the capabilities housed within Allspring's proprietary climate transition assessment framework.

Allspring has the resources to help clients better understand where their portfolio stands today and develop a strategy for the future, backed by our well-resourced Sustainability team, systems, and capabilities. Our goal is to help our clients be well prepared as the world evolves around them.



1. Carbon emissions include operational and first-tier supply chain greenhouse gas emissions. At the company level, carbon intensity reflects the sum of these emissions divided by revenue. A weighted-average carbon intensity is calculated using simple weighted average, excluding holdings without emissions coverage. The market value weights of the covered issuers are rescaled to sum to 100%. Data is presented in CO₂e/\$1M revenue.

2. We include direct emissions as well as first-tier indirect emissions. Direct GHG emissions are emissions from sources that are owned or controlled by the reporting entity. Indirect GHG emissions are emissions that are a consequence of the activities of the reporting entity but occur at sources owned or controlled by another entity: <https://ghgprotocol.org/calculation-tools-and-guidance>.



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