New EU climate benchmarks have spearheaded the development of flexible portfolio allocation tools that help investors transform their portfolio into an instrument for addressing climate change. This paper covers the new class of benchmarks and what they mean for investors.

Climate change; unsustainable urban growth; and air, water and land pollution all represent existential threats not only to global populations and societies, but also to businesses. While the physical risks that climate change poses to businesses are those that threaten all of us, there are many transitional risks to which certain companies will be less resilient. Transitional risks imply structural changes arising from policy changes and shifts in market preferences, norms and technology. This can be reflected in increased costs such as emissions legislation that results in carbon taxes, having to invest in new lower-emission technologies and raw materials, or declining consumer demand due to reputational risk, or products or services becoming redundant or obsolete.

But the transition to a low carbon economy also presents many new opportunities to innovate and streamline efficiencies. Organisations that innovate and develop new low-emission products and services may improve their competitive position and capitalise on shifting consumer and producer preferences. For example, many new investment opportunities exist around the future of energy as emerging technologies and AI software are improving and more closely linking energy generation, energy storage and energy usage. Furthermore, businesses which harness these technological advances are shifting their energy usage toward low emission energy sources and driving energy efficiency in order to save on energy costs. Increasingly investors are calling for companies to therefore set out their climate strategy to best capture these opportunities.

Despite the evolving opportunities to transition to a more sustainable future, drastic steps still need to be taken to formally address climate change. In 2015, a collective commitment by the world’s governments to combat climate change led to the United Nations’ Paris Agreement to pursue preventing global temperature rise. The Paris Agreement provides an ambitious roadmap; if commitments, policies and action can deliver a 7% greenhouse gas (GHG) emissions reduction every year between 2020 and 2030, global warming can be limited to 1.5°C, preventing the most catastrophic effects of climate change. To reach these energy and climate goals by 2030, around
€180bn in additional yearly funding will be needed. Policymakers, financial institutions, businesses and investors share a collective responsibility in driving these efforts.

THE EUROPEAN UNION’S (EU’S) ACTION PLAN

Through the EU Action Plan for Sustainable Finance, the European Commission (EC) has sought to hardwire sustainability considerations into the financial system, and is seeking to channel public and private capital towards investments to meet the decarbonisation targets. As part of the Action Plan, the EC established the Technical Expert Group (TEG) on sustainable finance in 2018 to advise on the objectives and steps needed. As detailed below, one of the steps was to develop sustainability benchmarks to promote Paris-aligned investments. The TEG set out minimum standards on two types of climate benchmarks that aim to provide clear rules that ensure the indexes are comparable and transparent: the EU Climate Transition Benchmark (EU CTB) and the EU Paris-Aligned Benchmark (EU PAB).

EXHIBIT 1: THE EU ACTION PLAN FOR SUSTAINABLE FINANCE

The EU climate benchmarks seek to:

- Increase transparency on investors’ impact, specifically with climate change and energy transition.
- Allow comparability between climate benchmarks while leaving benchmark administrators with flexibility in their methodologies.
- Reduce the risk of greenwashing through common standards, objectives and quantitative metrics.
Evolutions in Climate Change Investing: EU Climate Benchmarks

Before the development of these new benchmarks, low-carbon index construction has focused on two principle approaches. One is “exclusions”-driven, namely identifying and removing those companies using fossil fuels, and the other is “carbon-tilted,” with index weights adjusted positively toward companies demonstrating reduced emissions.

The new climate benchmarks leverage the rapidly growing pool of available data and analytics, assessing how aligned each underlying company is to a 1.5 or 2°C global warming scenario. Not only do they aim to hedge against climate transition risks (backward looking), but also to capture opportunities (forward looking). Research includes independently assessed science-based targets, CO₂ emissions, and forward-looking product, strategy, emissions and policy plans.

As seen in Exhibit 2 below, while both climate benchmarks meet the minimum standards set out by the TEG, the PAB is the more stringent of the two. Compared to EU CTB, the EU PAB:

- Calls for a higher level of decarbonization versus the underlying investable universe.
- Has additional exclusions based on activities that lead to high GHG emissions. Companies which are currently excluded from the index due to a high reliance on fossil fuels, should they transition their energy mix, could in the future be eligible to join the index.

### EXHIBIT 2: EU CLIMATE BENCHMARK MINIMUM STANDARDS

<table>
<thead>
<tr>
<th>Risk-oriented minimum standards</th>
<th>EU Climate Transition Benchmark (CTB)</th>
<th>EU Paris-Aligned Benchmark (PAB)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Help reduce exposure to climate-related financial risks including stranded asset, transition &amp; physical risks</strong></td>
<td>30% decarbonization vs benchmark</td>
<td>50% decarbonization vs benchmark</td>
</tr>
<tr>
<td>Carbon Intensity Reduction</td>
<td>Significant reduction in total GHG emission intensity compared to the investable universe</td>
<td></td>
</tr>
<tr>
<td>Scope 1+2 (+3) emissions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scope 3 Phase-In</td>
<td>Up to a four-year timeframe to account for all direct and indirect emissions</td>
<td></td>
</tr>
<tr>
<td>Baseline Exclusions</td>
<td>Controversial weapons; Societal norms violators; Violators of UN Global Compact Principles; Tobacco</td>
<td>Coal (1%+ revenues); Oil (10%+ revenues); Natural gas (50%+ revenues); Electricity producers with carbon intensity of lifecycle</td>
</tr>
<tr>
<td>Activity Exclusions</td>
<td>No</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Opportunity-oriented minimum standards</th>
<th>EU Climate Transition Benchmark (CTB)</th>
<th>EU Paris-Aligned Benchmark (PAB)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Help direct capital to those companies leading the transition to a low-carbon economy</strong></td>
<td>At least 7% per annum; in line with or beyond the decarbonization trajectory from the IPCC’s 1.5C scenario</td>
<td></td>
</tr>
<tr>
<td>Self-Decarbonization</td>
<td>Year-on-year self-decarbonization of the benchmark</td>
<td></td>
</tr>
<tr>
<td>Exposure Constraints</td>
<td>Minimum exposure to sectors highly exposed to climate change issues is at least equal to market benchmark value</td>
<td></td>
</tr>
<tr>
<td>Corporate Target Setting</td>
<td>Weight increase shall be considered for companies which set evidence-based targets under strict conditions to avoid greenwashing</td>
<td></td>
</tr>
</tbody>
</table>

PARIS-ALIGNED INDEXES: FLEXIBLE PORTFOLIO CONSTRUCTION TOOLS FOR ADDRESSING CLIMATE CHANGE

With the PAB being more stringent than the CTB, several leading index providers have built indexes based off these standards, serving as a benchmarking tool for those looking to be at the forefront of climate transition investing.

As an early entrant into the Paris-aligned space, Franklin Templeton has launched two passive Undertakings for the Collective Investment in Transferable Securities (UCITS) exchange-traded funds (ETFs) that are fully compliant with the PAB. The S&P 500 Paris-Aligned Climate Index and the STOXX Europe 600 Paris-Aligned Benchmark Index were selected as the underlying benchmarks.²

While not the only providers to build PAB indexes, S&P and STOXX were selected by Franklin because their Paris-aligned versions aim to remain as close as possible to the parent indexes. This enables investors to retain the broad, diversified exposure benefits of these markets while aligning with the climate goals of the Paris Agreement. Moreover, unlike other index providers who generally rely on in-house research capabilities, S&P and STOXX have partnered with leading carbon data specialists—Trucost and ISS, respectively—enabling them to build methodologies that integrate state-of-the-art data sets and analysis. As a result, these Paris-aligned indexes have ambitious carbon reduction targets, as well as meaningful broader environmental, social and governance (ESG) components.

WHAT DOES THIS MEAN FOR INVESTORS?

Franklin Templeton’s new Paris-aligned UCITS ETFs exemplify how the new EU climate benchmarks have spearheaded the development of flexible portfolio allocation tools that help investors transform their portfolio into an instrument for addressing climate change. We believe that as investors seek to decarbonise portfolios and actively measure and manage climate risk in line with their investment liabilities, that they will seek proactive climate solutions. With the diversified structure of these funds, investors can move away from the notion that these are niche products and instead use them in a variety of ways.

Flows into sustainable ETFs more than doubled in 2019 and global ESG ETF assets are $88bn worldwide.³ We believe this momentum is likely to continue through a combination of changing investor preferences and regulation. European and Asian regulators increasingly seek demonstrable evidence of ESG integration and management of climate risk, while investor demand for sustainable investments looks set to continue its strong growth trajectory, across many investor types, from millennials and private wealth, through to insurance schemes.
WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments.

Brokerage commissions and ETF expenses will reduce returns. ETF shares may be bought or sold throughout the day at their market price on the exchange on which they are listed. ETFs trade like stocks, fluctuate in market value and may trade above or below the ETF’s net asset value. However, there can be no guarantee that an active trading market for ETF shares will be developed or maintained or that their listing will continue or remain unchanged. While the shares of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

Diversification does not guarantee profit nor protect against risk of loss.

The companies and case studies shown herein are used solely for illustrative purposes; any investment may or may not be currently held by any portfolio advised by Franklin Templeton Investments. The opinions are intended solely to provide insight into how securities are analyzed. The information provided is not a recommendation or individual investment advice for any particular security, strategy, or investment product and is not an indication of the trading intent of any Franklin Templeton managed portfolio. This is not a complete analysis of every material fact regarding any industry, security or investment and should not be viewed as an investment recommendation. This is intended to provide insight into the portfolio selection and research process. Factual statements are taken from sources considered reliable, but have not been independently verified for completeness or accuracy. These opinions may not be relied upon as investment advice or as an offer for any particular security. Past performance does not guarantee future results.

Endnotes
2. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
IMPORTANT LEGAL INFORMATION

This material is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice.

The views expressed are those of the investment manager and the comments, opinions and analyses are rendered as at publication date and may change without notice. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market. All investments involve risks, including possible loss of principal.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton (“FT”) has not independently verified, validated or audited such data. FT accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

Products, services and information may not be available in all jurisdictions and are offered outside the U.S. by other FT affiliates and/or their distributors as local laws and regulation permits. Please consult your own financial professional or Franklin Templeton institutional contact for further information on availability of products and services in your jurisdiction.

Issued in the U.S. by Franklin Templeton Distributors, Inc., One Franklin Parkway, San Mateo, California 94403-1906, (800) DIAL BEN/342-5236, franklintempleton.com—Franklin Templeton Distributors, Inc. is the principal distributor of Franklin Templeton U.S. registered products, which are not FDIC insured; may lose value; and are not bank guaranteed and are available only in jurisdictions where an offer or solicitation of such products is permitted under applicable laws and regulation.

Australia: Issued by Franklin Templeton Investments Australia Limited (ABN 87 006 972 247) (Australian Financial Services License Holder No. 225328), Level 19, 101 Collins Street, Melbourne, Victoria, 3000. Germany: Issued by Franklin Templeton Investment Services GmbH, Frankfurt, Mainzer Landstr. 16, 60325 Frankfurt/Main, Tel: 08 00/0 73 80 01 (Germany), 08 00/29 59 11 (Austria), Fax: +49(0)69/2 72 23-120, info@franklintempleton.de, info@franklintempleton.at. Canada: Issued by Franklin Templeton Investments Corp., 200 King Street West, Suite 1500 Toronto, ON, M5H3T4, Fax: (416) 364-1163, (800) 387-0830, www.franklintempleton.ca. Netherlands: Issued by Franklin Templeton International Services S.A. r.l., Dutch Branch, World Trade Center Amsterdam, H-Toren, Se verdieping, Zuulplein 36, 1077 XV Amsterdam, Netherlands. Tel: +31 (0) 20 575 2890. United Arab Emirates: Issued by Franklin Templeton Investments (ME) Limited, authorized and regulated by the Dubai Financial Services Authority. Dubai office: Franklin Templeton, The Gate, East Wing, Level 2, Dubai International Financial Centre, P.O. Box 506613, Dubai, U.A.E., Tel: +9714-4284100, Fax: +9714-4284140. France: Issued by Franklin Templeton International Services S.A. r.l., French branch, 20, rue de la Paix, 75002 Paris, France. Hong Kong: Issued by Franklin Templeton Investments (Asia) Limited, 17/F, Chater House, 8 Connaught Road Central, Hong Kong. Italy: Issued by Franklin Templeton International Services S.A.r.l. – Italian Branch, Corso Italia, 1 – Milan, 20122, Italy. Japan: Issued by Franklin Templeton Investments Japan Limited. Korea: Issued by Franklin Templeton Investment Trust Management Co., Ltd., 3rd fl., CCMM Building, 12 Huido-Dong, Youngdong-Gu, Seoul, Korea 150-958. Luxembourg/Benelux: Issued by Franklin Templeton International Services S.A. r.l. – Supervised by the Commission de Surveillance du Secteur Financier – 8A, rue Albert Borschette, L-1245 Luxembourg, Tel: +352 46 66 67-1, Fax: +352 46 66 76. Malaysia: Issued by Franklin Templeton Asset Management (Malaysia) Sdn. Bhd. & Franklin Templeton GSC Asset Management Sdn. Bhd. Poland: Issued by Templeton Asset Management (Poland) TFI S.A.; Rondo ONZ 1; 00-124 Warsaw, Poland. Romania: Issued by Buchararest branch of Franklin Templeton Investment Management Limited (“FTIML”) registered with the Romania Financial Supervisory Authority under no. FMG013FMI/400005/14.09.2009, and authorized and regulated in the UK by the Financial Conduct Authority. Singapore: Issued by Templeton Asset Management Ltd. Registration No. (UEN) 199205211E. 7 Temasek Boulevard, #38-03 Suntec Tower One, 038987, Singapore. Spain: Issued by Franklin Templeton International Services S.A. r.l. – Spanish Branch, Professional of the Financial Sector under the Supervision of CMV, José Ortega y Gasset 29, Madrid, Spain. Tel: +34 91 426 3600, Fax: +34 91 577 1857. South Africa: Issued by Franklin Templeton Investments SA (PTY) Ltd which is an authorised Financial Services Provider. Tel: +27 (21) 831 7400, Fax: +27 (21) 831 7422. Switzerland: Issued by Franklin Templeton Switzerland Ltd, Stockerstrasse 38, CH-8002 Zurich. UK: Issued by Franklin Templeton Investment Management Limited (“FTIML”), registered office: Cannon Place, 78 Cannon Street, London EC4N 6HL, Tel: +44 (0)20 7073 8500. Authorized and regulated in the United Kingdom by the Financial Conduct Authority. Nordic regions: Issued by Franklin Templeton International Services S.A. r.l. – Contact details: Franklin Templeton International Services S.A. r.l., Swedish Branch, filial, Nybrovägen 5, SE-111 48, Stockholm, Sweden. Tel: +46 (0)8 545 012 30, nordicinfo@franklintempleton.com, authorised in the Luxembourg by the Commission de Surveillance du Secteur Financier to conduct certain financial activities in Denmark, in Sweden, in Norway, in Iceland and in Finland. Franklin Templeton International Services S.A. r.l., Swedish Branch, filial conducts activities under supervision of Finansinspektionen in Sweden. Offshore Americas: In the U.S., this publication is made available only to financial intermediaries by Templeton/Franklin Investment Services, 100 Fountain Parkway, St. Petersburg, Florida 33716. Tel: (800) 239-3894 (USA Toll-Free), (877) 389-0076 (Canada Toll-Free), and Fax: (727) 299-8736. Investments are not FDIC insured; may lose value; and are not bank guaranteed. Distribution outside the U.S. may be made by Templeton Global Advisors Limited or other sub-distributors, intermediaries, dealers or professional investors that have been engaged by Templeton Global Advisors Limited to distribute shares of Franklin Templeton funds in certain jurisdictions. This is not an offer to sell or a solicitation of an offer to purchase securities in any jurisdiction where it would be illegal to do so. Please visit www.franklinresources.com to be directed to your local Franklin Templeton website.

CFRA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.