Press Release **Boston, London, Nice, Paris, Singapore, Tokyo, November 12, 2020**

Scientific Beta criticises use of Enterprise Value in European Benchmark Regulation

European Benchmark Regulation's switch from a robust market standard to alternative indicators is unhelpful in the pursuit of climate change mitigation

If global warming is to be curtailed to 1.5°C, then there is an urgent need for net greenhouse gas emissions to be sharply reduced, an achievement which can only be met by dramatic reductions in the carbon intensities of human activities.

Normalisation of emissions by revenues is an established standard in the market and a feature of the weighted average carbon intensity metric recommended for reporting by the Task Force on Climate-related Financial Disclosures.[1] However, the proposed delegated act setting out the requirements for EU Climate Benchmarks has recently mandated the use of enterprise value including cash for normalisation. This variation on carbon intensity has not been properly justified or thought through. The group that assisted the regulator represented that the shift from market value of products and services to market valuation of the producer would be detrimental to the coal industry and that enterprise-value-based carbon intensity would be applicable across equity and fixed income indices. However, beyond coal, all companies with a lower than average enterprise value to sales ratio suffer from this unjustified shift.

Stakeholder feedback led the regulator to account for some of the data issues and biases plaguing enterprise value. However, a fundamental issue that remains insufficiently addressed is that enterprise value embarks equity market volatility. This weakens the link between changes in measured carbon intensity and underlying emissions, and produces carbon intensity volatility that facilitates greenwashing. In both respects, the market standard appears preferable.

In a new white paper entitled "Carbon Intensity Bumps on the Way to Net Zero," Scientific Beta's Frederic Ducoulombier, ESG Director, and Victor Liu, Quantitative Analyst, conclude that the European Benchmark Regulation's switch from a robust market standard to alternative indicators is unhelpful in the pursuit of climate change mitigation. From a climate impact point of view, one should avoid guiding portfolio construction by enterprise value-based carbon intensity. Investors wishing to allocate to EU Climate Benchmarks without encouraging greenwashing should ensure methodologies make use of this metric to the minimum extent required for compliance.

The Scientific Beta white paper on the subject can be accessed through the link below:
Carbon Intensity Bumps on the Way to Net Zero

Issues with the EU regulation and emissions data are further discussed in two other white papers:
A Critical Appraisal of Recent EU Regulatory Developments Pertaining to Climate Indices and Sustainability Disclosures for Passive Investment
Understanding the Importance of Scope 3 Emissions and the Implications of Data Limitations

[1] Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures, Financial Stability Board, 2017, p. 44.

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About Scientific Beta

Scientific Beta aims to be the first provider of a smart beta indices platform to help investors understand and invest in advanced beta equity strategies. Established by EDHEC-Risk Institute, one of the top academic institutions in the field of fundamental and applied research for the investment industry, Scientific Beta shares the same concern for scientific rigour and veracity, which it applies to all the services that it offers investors and asset managers. On January 31, 2020, Singapore Exchange (SGX) acquired a majority stake in Scientific Beta. SGX is maintaining the strong collaboration with EDHEC Business School, and principles of independent, empirical-based academic research, that have benefited Scientific Beta's development to date.

The Scientific Beta offering covers three major services:

- **Scientific Beta Indices**
  Scientific Beta Indices are smart beta indices that aim to be the reference for the investment and analysis of alternative beta strategies. Scientific Beta Indices reflect the state-of-the-art in the construction of different alternative beta strategies and allow for a flexible choice among a wide range of options at each stage of their construction process. This choice enables users of the platform to construct their own benchmark, thus controlling the risks of investing in this new type of beta (Smart Beta 2.0).

  Within the framework of Smart Beta 2.0 offerings, Scientific Beta provides access to smart factor indices, which give exposure to risk factors that are well rewarded over the long term while at the same time diversifying away unrewarded specific risks. By combining these smart factor indices, one can design very high performance passive investment solutions.

- **Scientific Beta Analytics**
  Scientific Beta Analytics are detailed analytics and exhaustive information on its smart beta indices to allow investors to evaluate the advanced beta strategies in terms of risk and performance. The analytics capabilities include risk and performance assessments, factor and sector attribution, and relative risk assessment. Scientific Beta Analytics also allow the liquidity, turnover and diversification quality of the indices offered to be analysed. In the same way, analytics provide an evaluation of the probability of out-of-sample outperformance of the various strategies present on the platform.

- **Scientific Beta Fully-Customised Benchmarks and Smart Beta Solutions** is a service proposed by Scientific Beta, and its partners, in the context of an advisory relationship for the construction and implementation of benchmarks specially designed to meet the specific objectives and constraints of investors and asset managers. This service notably offers the possibility of determining specific combinations of factors, considering optimal combinations of smart beta strategies, defining a stock universe specific to the investor, and taking account of specific risk constraints during the benchmark construction process.

With a concern to provide worldwide client servicing, Scientific Beta is present in Boston, London, Nice, Singapore and Tokyo. As of December 31, 2019, the Scientific Beta indices corresponded to USD 59.2bn in assets under replication. Scientific Beta has a dedicated team of 52 people who cover not only client support from Nice, Singapore and Boston, but also the development, production and promotion of its index offering. Scientific Beta signed the United Nations-supported Principles for Responsible Investment (PRI) on September 27, 2016.

On November 27, 2018, Scientific Beta was presented with the Risk Award for Indexing Firm of the Year 2019 by the prestigious professional publication Risk Magazine. On October 31, 2019, Scientific Beta received the Professional Pensions Investment Award for “Equity Factor Index Provider of the Year 2019.”