Article
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Climate Investing
Moving From Conversation To Action

- **Significant developments in 2018 are moving investors to take greater action to address the impacts of climate change in their investment portfolios.**
- **Commitments by investors to the Task Force on Climate-related Financial Disclosure (TCFD), as well as existing and pending regulation in Europe, are quickly advancing the financial industry's response to climate change.**
- **Due to evolving climate science and regulation, investors are on a journey when it comes to understanding and responding to climate change.**
- **State Street Global Advisors has developed a suite of capabilities to help clients meet their investment goals specific to climate challenges. These include a spectrum of climate-related investment solutions, from exclusionary and mitigation solutions to those that also incorporate adaptation.**

A Growing Need For Climate Action

For decades, experts have warned that the physical, economic, and regulatory risks posed by climate change could mean significant losses for investors. Consequently, investors have been debating how to interpret and measure climate risk in their portfolios and what actions can help safeguard investment from a risk and return perspective.

In 2018, three key developments helped shift the climate conversation from debate to action and have created a new sense of urgency among investors. They include:

- **Clear manifestation of the physical impacts of climate change.** As extreme weather events have become more frequent, the physical impacts of climate change have become more visible and obvious. In Australia, for example, it is predicted that the impacts of prolonged drought on the agriculture sector caused by changing climate patterns over the last few years may reduce Australia's GDP by a full percentage point over a two-year period.[1]
- **Quantification of economic risk.** In November 2018, a report published by 13 United States government agencies drew widespread attention. It warned that without significant steps to address global warming, annual losses in some economic sectors could reach hundreds of billions of dollars by 2100.[2]
- **Climate regulation**. An overhaul of the European legislative framework that will directly impact investors made significant advances in 2018,[3] as Europe begins to operationalize the Paris Climate Agreement. In the UK, the regulators are also exploring means to implement the recommendations set out by the TCFD.

Together, these developments have crystalized for investors the urgent need for taking action to limit the impact of climate change on their portfolios. In this paper, we aim to support that action by:

- Highlighting climate-related regulatory developments that are influencing investors' portfolio needs;
- Outlining a range of approaches available to address climate change within an investment portfolio; and
- Providing an overview of State Street Global Advisors' climate capabilities.

Aligning Action With Climate Commitment

Against the backdrop of the macro developments outlined above, at State Street Global Advisors, clients seek our guidance based on two key drivers of action:

The Evolving Regulatory Landscape: Clients are working to meet evolving regulatory and voluntary climate-related obligations (e.g. disclosures).

A Desire to Align Investors' Actions with Organizational Objectives: Clients are expanding their investment objectives to include climate-related goals, prompted by the physical and economic impacts of climate change.

Below, we describe these drivers in detail.

The Evolving Regulatory Landscape

Investors are striving to stay abreast of the evolving regulatory landscape with respect to climate change. In recent years, governments — especially in Europe — have increased efforts to operationalize their commitments made through the Paris Accord. This complements the work of the Financial Stability Board's TCFD that produced voluntary guidelines.

To meet the commitments articulated in the Paris Accord, European policymakers aim to "mainstream" sustainability into the existing legislative framework, most notably embedding explicit requirements to assess, disclose, and mitigate long-term climate-related risks. This is because policymakers view the financial services sector as having an important role in achieving those commitments. The European Climate Legislation Initiatives located on page 2 provide an overview of the existing and incoming legislation that is driving investors to seek out climate solutions to help meet their regulatory obligations.

Additionally, both governments and investors are increasingly looking for ways to comply with the TCFD's framework, which focuses on assessing, responding to, and disclosing climate risks in investment portfolios. At present, two thirds of G20 countries, including Australia, Hong Kong, Japan, South Africa, and the United Kingdom, have engaged with the TCFD[4] and have either conducted private sector consultations on sustainable finance and disclosure, or issued disclosure guidelines and frameworks. At the same time, investors have committed to comply with the Task Force's recommendations, and are working to find investment solutions that help them demonstrate alignment.

European Climate Legislation Initiatives

European Climate Targets

As part of its signing to the 2015 Paris Accord, the European Commission has committed to three climate and energy targets by 2030:
- 40% reduction of greenhouse gas emissions
- 27% renewables in final energy consumption
- 30% energy savings

Examples of Existing European Legislation

European Union
- The Non-financial Reporting Directive compels certain companies to include business-specific disclosure on environmental matters and other ESG data in a new Non-Financial Information Statement (NFIS)
- The revised Shareholder's Rights Directive requires institutional investors and asset managers to develop an engagement policy that strengthens shareholder engagement and promotes long-term sustainability.

France Since 2015, France has enacted national legislation aiming to reduce greenhouse gas emissions by 40% by 2030 compared to 1990 levels.
- Institutional investors are required to annually disclose how governance factors are integrated into their asset management practices.
- Managers with more than €500 million under management must also disclose how they assess climate-related portfolio risks and align capital allocation decisions to international and national low-carbon goals.

United Kingdom The Financial Reporting Council established a Corporate Governance Code and Stewardship Code to govern the interaction between the investor and investee company.

Forthcoming Legislation

2018 European Commission Action Plan on Sustainable Finance The European Commission's proposed rules would apply to asset owners, managers, insurance distributors, investment advisors as well as other market participants and aims to:
- Reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
- Manage financial risks stemming from climate change, resource depletion, environmental degradation, and social issues; and
- Foster transparency and long-termism in financial and economic activity.[5]

In May 2018, the Commission published proposals, and set up a Technical Expert Group (TEG), to further develop actions relating to ESG taxonomy, benchmarks, disclosures, and financial advice. We expect the final rules to be published in April 2019, following which secondary legislation will be developed.

Additionally, in 2018 the UK proposed to provide enhanced guidance to companies on their climate-related financial disclosures and to introduce broad-based public reporting requirements that would be fashioned on the TCFD recommendations.

Aligning Investors' Actions with Organizational Objectives

There are many ways to address climate change within a portfolio. As climate science and data availability improve, approaches to climate solutions evolve, offering investors a broader range of options to help meet their organization's investment objectives. Below, we have identified the common ways in which investors can express their climate commitment in their portfolios:

Exclusionary Screening. Targets meaningful carbon reduction across asset classes by:
- Screening out the companies with high emissions and fossil fuel reserves, and/or companies in key industries with significant climate-related risk exposure, such as coal.

This is implemented as a standalone screen or in combination with other investment approaches.

Mitigation. Targets specific net carbon reduction goals by:
- Reducing the carbon intensity of a portfolio by a desired percentage while staying within a specified tracking error range against a specific benchmark.
- Increasing exposure to companies generating 'green' revenues from low carbon opportunities.

Mitigation and Adaptation. Targets carbon reduction and provides exposure to businesses that are adapting to the impacts of climate change by:
- Reducing exposure to below-average carbon emitters, fossil fuel assets, and 'brown' revenues derived from extraction or power generation of fossil fuels.
- Increasing exposure to 'green' revenues and to companies that are adapting their business models to climate risks and opportunities.

This represents a new frontier in climate investing and is one of 5 Trends in ESG Investing in 2018.

Asset Stewardship.
- Regardless of portfolio approach, asset stewardship is an inextricable part of any climate investment approach.
- Climate stewardship allows for ongoing engagement with companies about the risks and opportunities presented by climate change.
- For some investors, this represents their primary climate-focused tool, regardless of whether they also invest in portfolios with specific climate objectives.

The appropriate approach for a particular investor depends on a variety of considerations, including investment objectives, climate-related objectives, and risk tolerance, among others.

A Spectrum of Climate Investment Solutions

Exclusionary
Screen Out
- Worst polluters
- Fossil fuel reserves
- Coal

Mitigation
Target Net Carbon Emission Reduction
- Reduce exposure to carbon intensity and fossil fuel reserves
- Increase exposure to companies generating revenues from low carbon opportunities (green revenues)

Mitigation and Adaptation
Mitigate and Adapt in a Risk-Controlled Way
- Reduce exposure to worse-than-average carbon emission, fossil fuel assets (carbon reserves), and brown revenues
- Increase exposure to companies generating revenues from low carbon opportunities (green revenues)
- Increase exposure to resilient companies (adaptaion)

Asset Stewardship

Source: State Street Global Advisors, MSCI, FTSE, S&P Trucost.

State Street Global Advisors' Capabilities

At State Street Global Advisors, we pride ourselves on being a full partner to our clients. With deep understanding of both climate science and the regulatory landscape, we work with clients to develop and implement investment responses to climate change. Our capabilities with respect to climate investing include **asset stewardship, access to climate data,** and **comprehensive solutions,** as outlined below.

Climate-focused Asset Stewardship

As climate change becomes an increasingly important consideration for investors assessing the long-run viability of companies around the world, our Asset Stewardship program has developed a rigorous and thoughtful engagement approach with portfolio companies. We use our position to ensure boards and management teams are overseeing and managing risks that might materially impact their company's ability to generate sustainable returns over the long term — and use both our voice and our vote to do so. We believe that boards should regard climate change as they would any other significant risk to the business and ensure that a company's assets and its long-term business strategy are resilient to the impacts of climate change. As a global investor, we see ourselves as an important accountability mechanism, holding the companies we invest in to a consistent set of reporting standards and investor expectations.

We have published guidance in this area, such as:

- Climate Change Risk Oversight for Directors, focused on the "high impact" sectors of oil, gas, utilities, and mining
- Incorporating Sustainability into Long-Term Strategy
- State Street Global Advisors' Perspectives on Effective Climate Change Disclosure

We continue to explore new challenges, including an upcoming paper that analyzes the quality of climate disclosure in the agriculture and forestry sectors. We focus on these sectors because agriculture alone accounts for 24% of greenhouse gas emissions and due to the significant potential impacts of climate change on these sectors.

Climate Data

Quality climate data is essential for developing targeted investment solutions. To provide our clients with a variety of investment solutions, we have built an ESG and climate data architecture, integrating relevant carbon and environmental metrics from multiple data providers, including S&P TruCost, FTSE Russell Green Revenues, and ISS-ESG.[6] Our platform includes company-reported greenhouse gas emissions data, as well as information about 'green' and 'brown' revenues, company adaptation to climate change, and other relevant data points. This platform, along with extensive research in equity and fixed income portfolio construction (both active and index), allows us to offer a spectrum of investment solutions.

Solutions

Our investment solutions include both investable opportunities, as well as climate-specific reporting capabilities.

Investments. We have the capabilities to offer investable solutions across the range of climate investment styles described above: exclusionary screening, mitigation, mitigation and adaptation, and asset stewardship. Our approaches are backed by science-based targets set forth by the Intergovernmental Panel on Climate Change (IPCC), and have the opportunity to scale more or less aggressively towards keeping global temperature rise less than 2°C above pre-industrial levels. As climate science evolves and the goals set forth by the global scientific community become more aggressive, our investment solutions have the capabilities to continue tracking those goals.

Climate-Specific Reporting. Our climate reporting solutions are designed to help clients understand how their strategies perform against investment objectives, including climate-focused objectives. The reports also help clients meet regulatory obligations, as well as their reporting obligations to beneficiaries, trustees, and other stakeholders. We are also developing portfolio-level analytical capabilities to support deeper understanding of the portfolio impacts of transitioning to a low carbon economy.

We hope this look into Climate Investing, Moving from Conversation to Action supplies you with ideas to leverage when considering climate investment decisions. As always, we invite you to contact your State Street Global Advisors Relationship Manager or access our ESG website at ssga.com/esg to learn more about these resources and our ESG capabilities.

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Endnotes

1 http://aicd.companydirectors.com.au/membership/company-director-magazine/2018-back-editions/october/economist-the-big-dry

2 https://nca2018.globalchange.gov/

3 European Commission Action Plan on Sustainable Finance, published in March 2017

4 https://www.cisl.cam.ac.uk/resources/sustainable-finance-publications/sailing-from-different-harbours

5 European Commission Action Plan: Financing Sustainable Growth https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN

6 We have relationships with and access to data from S&P TruCost (carbon), ISS-Oekem (multiple climate metrics, including adaptation) and FTSE LCE (green revenues, fossil fuel metrics, and carbon)