A Case For: An Active Fundamental Approach to Climate Transition

Environmental, Social & Governance (ESG)

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A determined effort by both the public and private sectors to bring about a 50% reduction in greenhouse gas emissions by 2030 offers the potential for significant capital growth in equities. This new era of climate transition, which will be followed by the transition to net-zero emissions by 2050, presents equity investors with clear opportunities for generating significant alpha using an active, high-conviction approach to investing.

The global economy is fast transitioning from being dependent on fossil fuels to being driven by clean energy. Governments and companies are taking concrete steps to avoid the worst climate impacts by achieving net-zero emissions by 2050. Countries with net-zero targets together represent 88% of global emissions,[1] 90% of global GDP,[2] and 85% of the global population.[3]

While the financial markets are expected to mobilize trillions of dollars to build a global zero-emissions economy, vast investment in new technologies and capital equipment will also be required to realize emissions reductions of 50% or more by 2030 and a net-zero transition by 2050.

In November 2021, the United Nations Climate Change Conference (COP26) focused the world spotlight on the need for urgent global action. Ambitious country-level pledges to limit carbon emissions, reduce methane emissions, and end the use of coal made headlines. COP26 also spurred a series of impactful regulatory and economic drivers that have the potential to dramatically reshape equity investing.

One key regulatory outcome from COP26 was the establishment of the new International Sustainability Standards Board (ISSB), which is overseen by the International Financial Reporting Standards (IFRS) body. ISSB is presently consulting on standardized corporate climate-related disclosure guidelines for investors, leveraging existing global frameworks like TCFD[4] and the former SASB.[5] The ISSB guidelines, which are expected to be announced in the second half of 2022, aim to set a "high-quality, comprehensive global baseline" on ESG disclosure for the financial markets.

On the carbon front, mandatory emissions disclosures and carbon pricing may eventually be applied all along the supply chain,[6] which could upend current company scores for carbon-intensity and other greenhouse gas (GHG) measures.

1 Net zero means that carbon emissions are either eliminated or offset.
2 In purchasing power parity terms.
3 https://netzeroclimate.org as of 24 March 2022.
4 Task Force on Climate-Related Financial Disclosures.
5 Sustainability Accounting Standards Board.
6 Scope 3 emissions include all indirect GHG emissions that occur in a company's value chain.

Corporate Transition Planning

In a climate-focused world, companies will be expected to have a credible transition plan for achieving net-zero emissions. Mandatory disclosure on climate-related factors and hard carbon pricing will be a benefit to the planning process, leading to greater accuracy in quantifying the true cost of emissions. Companies will be assessed on their transition plans as well as on their current progress with regard to their carbon footprint. Regulatory and physical risks to companies, including the short- and long-term impacts of climate change, will also be assessed.

By definition, transition plans will be forward-looking, and some companies may find themselves having to make new investments or undertake restructuring in order to achieve net-zero emissions in the allotted timeframe. Other companies may find themselves already advantageously positioned to benefit from efforts to tackle climate change.

Corporate transition plans are therefore expected to come under sharp stock market scrutiny. Climate transition planning and competency will become key areas of differentiation for companies — and will become key drivers of valuation for all equities. In the shifting climate landscape, there will be re-ratings, valuation dislocations, and corporate winners and losers — all creating an environment ripe for active stock-picking.

Climate Investing Using an Active Fundamental Approach

State Street's Fundamental Growth & Core Equity (FGC) team takes an active, high-conviction approach to equity investing in general, and to climate investing specifically. FGC's long-term, forward-looking approach, in-depth company-level research, and low turnover align well with the climate investment landscape. The FGC team looks for quality companies at reasonable valuations that can deliver growth that is stronger and more enduring than the market's expectations. Since relatively few companies meet our strict criteria for investment, we concentrate our portfolios in our highest-conviction names.

As a team, we get to know our portfolio companies very well, through deep due diligence and engagement. We seek to hold companies for the long term, investing like owners rather than traders — five years is a typical holding period. While the market tends to focus on short-term results, we believe that investors who have the judgment, patience, and perspective to look beyond the horizon of the average investor — as is necessary with climate investing — have an enormous advantage in the market because sustainable growth compounds over time.

FGC Climate Assessments

ESG considerations are integral to the FGC team's alpha thesis and have been fully integrated into the team's investment process since 2002. In recent years, we have continued to enhance our ESG research efforts to align with the evolving climate landscape. FGC analysts now conduct proprietary, in-house climate assessments across companies in their respective industries, scoring three key areas:

Climate Transition Readiness which includes disclosure practices, transition plan credibility, and management accountability

Climate Risks both financial and physical — including direct exposure to carbon pricing, risk of stranded assets, exposure to regulation or litigation, and exposure to severe weather and/or supply chain disruption

Climate-enabling Opportunities including green products, services, and solutions

Analyst climate assessments are captured on a Climate Scorecard, which is fully integrated into the FGC research framework and shared across the FGC platform. These climate scores and analyst insights form the foundation of our climate investing efforts.

State Street's Global Climate Transition Strategy

The FGC-managed Global Climate Transition Strategy is a dedicated ESG strategy that aims to generate long-term capital growth through investment in companies that lead their respective industries in climate change transition-preparedness and progress. The Global Climate Transition Strategy's "alpha thesis" capitalizes on the following attributes:

- **Fundamental Business Knowledge** FGC research analysts are subject-matter experts in their respective industries, well-positioned to assess company risks and opportunities as transition plans evolve.
- **Time-arbitrage** Corporate climate transition plans will play out over the next decade (and beyond) and require patience as frameworks develop and market valuations adjust.
- **Data Inadequacy** Forward-looking, fundamental analysis of companies is essential because much of the available climate data is historical or represents a snapshot in time.
- **Engagement** FGC has access to firmwide ESG and Asset Stewardship resources. FGC meetings with current and potential portfolio companies, and collaboration with State Street's Asset Stewardship team, generate key insights into each company's intended net-zero pathway and progress.

Figure 1 **Global Climate Transition Strategy**
Overview

An integrated portfolio focused on industry leaders in climate transition planning and progress

Development Approach	Characteristics
Based on the FGC team's investment philosophy of Quality, Sustainable Growth, and Reasonable Valuation	Number of holdings: 30–40
Using proprietary FGC Confidence Quotient (CQ) framework[7] to assess company quality	Benchmark: MSCI ACWI
Leveraging fully integrated climate and ESG research conducted by career FGC industry analysts	Target Excess Return: +300 bps
Managed by seasoned, global equity portfolio management team[8]	Target Information Ratio: 0.5
	Tracking Error: 4%–8%
	Aligned with SFDR/TCFD Disclosure Requirements

Source: State Street Global Advisors.

Conclusion

Global equity markets are being changed by country, corporate, and investor efforts to reduce greenhouse gas emissions and achieve net-zero objectives — at a pace never seen before. To discern the winners and losers in this evolving landscape, State Street's FGC team believes that an active, forward-looking approach, based on in-depth fundamental analysis, is most effective. Our team invests for the long term, informed by an assessment of corporate climate risks and opportunities as well as readiness for climate transition — characteristics that are fully integrated into our overall ESG framework.

Our concentrated portfolios reflect our highest-conviction, best ideas based on our rigorous and time-tested investment philosophy of quality, sustainable growth, and reasonable valuation. Our track record reflects the strength of our global analyst team and the stock-picking expertise of our seasoned portfolio managers.

We look forward to continuing this important conversation with you.

7 https://ssga.com/uk/en_gb/institutional/ic/insights/the-cq-framework-for-assessing-company-quality.
8 The Global Climate Transition strategy is managed by Esther Baroudy and John Flynn.

About State Street Global Advisors

State Street Global Advisors serves governments, institutions and financial advisors with a rigorous approach, breadth of capabilities and belief that good stewardship is good investing for the long term. Pioneers in index, ETF, and ESG investing and the world's fourth-largest asset manager*, we are always inventing new ways to invest.

* Pensions & Investments Research Center, as of December 31, 2020.

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Foreign investments involve political and economic risks and the risk of currency fluctuations. Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

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Other Risks

Currency Hedging Risk Hedges are sometimes subject to imperfect matching between the hedging transaction and the risk sought to be hedged. There can be no assurance that the strategy's hedging transactions will be effective. As the purpose of currency hedging is to try to reduce or eliminate losses caused by exchange rate fluctuations, it can also reduce or eliminate gains where the currency in which the strategy's assets are denominated appreciates.

Equity and Equity-Related Securities Risk The market prices of equity and equity related securities may go up or down, sometimes rapidly or unpredictably. The value of these securities may decline for reasons that directly relate to the issuer and/or due to general industry or market, such as real or perceived adverse economic conditions, changes in the general outlook for corporate earnings, changes in interest or currency rates, or adverse investor sentiment generally. Equity markets tend to move in cycles, which may cause stock prices to fall over short or extended periods of time.

ESG Risk If the strategy invests in companies taking into account environmental, social and corporate governance (ESG) criteria, then the performance of the strategy may trail the returns of a portfolio of securities that includes companies that are not excluded as a result of such ESG criteria. Investing only in a portfolio of securities that are not excluded as a result of such ESG criteria may affect the strategy's exposure to certain types of investments and may adversely impact the strategy's performance.

Integrating Sustainability Risk IntegratingSustainability Risk into the strategy's investment process does not assure the mitigation of any or all Sustainability Risk. Any deterioration in the financial profile of an underlying investment affected by a Sustainability Risk may have a corresponding negative impact on the Net Asset Value and/or performance of the strategy.

Modelling Risk The Investment Manager and/or Sub-Investment Manager uses quantitative models in an effort to enhance returns and manage risk. Any imperfections, errors or limitations in these models or in their programming could limit any benefit to the strategy from the use of the models, or could result in incorrect outputs or in investment outcomes different from or opposite to those expected or desired by the Investment Manager and/or Sub-Investment Manager. Such imperfections, errors or limitations might never be detected, or might be detected only after a strategy has sustained a loss (or reduced performance). Further, there can be no assurance that the models will behave as expected in all market conditions.

Screening Risk There is a risk that the screen provider may make errors, such as incorrect assessment of the screen criteria and/or include incorrect/exclude correct constituents in the screening process or discontinue its screening services. In such circumstances, the Company may change the screen provider although there is no guarantee that a replacement screen provided would result in a similar screening process to that intended or would be available at all.

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