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Fundamental Active Equities

New Drivers & New Approaches for Climate-Related Investing

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- **As COP26 approaches, a series of regulatory and economic drivers are emerging which have the potential to dramatically reshape equity investing.**

- **Climate transition planning and competency will become key areas of differentiation for companies.**

- **We see promising opportunities in both Climate Transition and Climate Opportunity Strategies.**

As we approach November's United Nations Climate Change Conference (COP26) we are seeing the emergence of new, and potentially dramatic, climate-related investment drivers which will shape equity portfolio investing for many years to come.

Moreover, a major new report (AR6) by the UN Intergovernmental Panel on Climate Change (IPCC) will only serve to strengthen policymakers' drive to channel financial market capital into faster and smarter climate solutions.

The new climate-related drivers have both regulatory and macro-economic dimensions. Regulatory factors may set the transition path to net-zero emissions while fiscal policies, which are expected to be largely tied to sustainability, may help determine the pace and structure of economic growth.

In some cases, publicly listed companies will need to have a credible transition plan to net-zero emissions. Additionally, there will be opportunity for a subset of these companies to derive revenue from the new economic growth drivers.

The transition to net-zero emissions in the next decade therefore sets the stage for determining distinct stock market winners and losers.

The transition to net-zero introduces a number of factors with the potential to greatly impact companies. A diverse set of regulatory and economic drivers are at play.

Key Regulatory Drivers

G7 Climate Commitment The G7 supports mandatory emissions disclosures for companies together with requirements for credible net-zero emissions transition plans. The implication of this is that carbon intensities will become transparent, including all along the supply chain, ie Scope 3 Greenhouse Gas (GHG) emissions. This could upend current scoring for company carbon intensities and other GHG measures.

Regulation and the Science The IPCC AR6 report stresses that climate change and the accumulation of greenhouse gases in the atmosphere are primarily due to human influence. Given this, we do not exclude that COP26 may see a tightening-up of policies on the transition towards net-zero emissions.

Sustainability Standards New IFRS sustainability standards are being developed to enable the move towards common climate-related financial disclosures with comprehensive reporting and data transparency. This will make genuine comparisons between companies possible.

Carbon Price Floors The IMF board is actively negotiating setting a carbon price floor for large emitting nations. This will be increased on an annual basis and these carbon price increases will likely impact some companies' costs and investment. This may, in turn, lead to equity market valuation revisions.

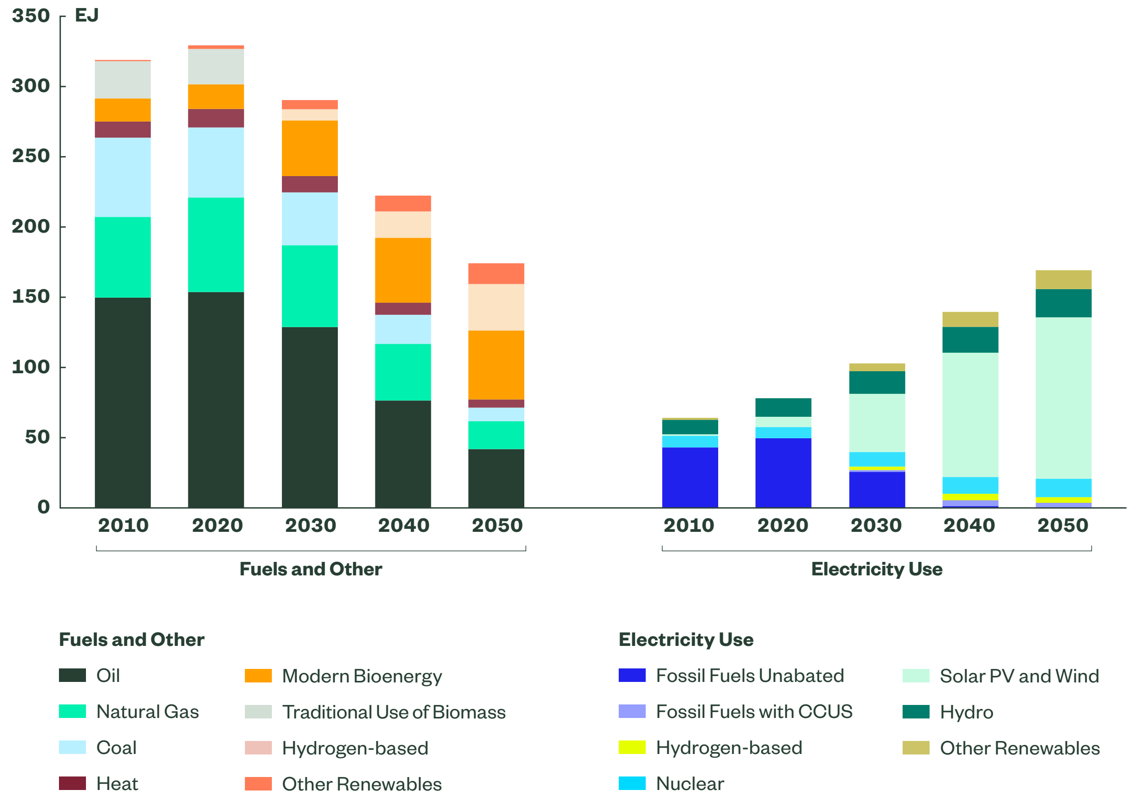
Key Economic Drivers

Fiscal Policy and Sustainability Fiscal policies are increasingly being tied to climate resilience and R&D. For example, in the United States, the multi-trillion fiscal packages currently going through the houses of Congress involve climate-related investment, including a strong emphasis on infrastructure resilience to climate change. In addition, a 'Made in America' manufacturing strategy for components is planned to accompany this. The impact of this on global supply chains (in addition to reshoring) is expected to be significant.

New Growth Drivers Fiscal policy could impact and change the structure of economic growth. President Biden is looking for 80% clean electricity and 50% economy-wide carbon emissions reductions by 2030. Achieving ambitious goals such as these will require new technologies and innovation in solar, wind and energy efficiency alongside new electricity system flexibility (Figure 1).

Digital Enablement Climate change measurement and opportunity enablement will also require digital solutions. We anticipate an acceleration in investment in software and artificial intelligence techniques, including for automation and 'digital twinning'.

Figure 1
Global Total Final Energy Consumption by Fuel in the Net-Zero Emissions Scenario



Source: International Energy Agency (2021), Net-Zero by 2050, IEA, Paris IEA. Note: The share of electricity in final energy use jumps from 20% in 2020 to 50% in 2050.

Companies and the Transition to Net-Zero

In a climate-focused world, companies will be expected to have a credible transition plan for net-zero emissions. Companies will be assessed on their future transition plans as well as on their progress with regards to their current carbon footprint and regulatory and physical risks. Many companies are already preparing themselves for transition.

By definition, transition plans will be forward-looking, and companies may find themselves having to make new investments or to undertake restructuring in order to achieve net-zero emissions in the allotted timeframe.

Corporate transition plans can therefore be expected to come under stock market scrutiny going forward.

- Management and board directors may be assessed on climate credibility and resilience planning. They may face votes against them by asset managers and owners should they not comply.

- The ease of sector de-carbonization may become a factor. Ratings agencies may rate transition plans when they assign corporate debt ratings. In addition, financial intermediaries may be subject to central bank stress testing of assets.

- The credibility of transition plans to achieve net-zero emissions by 2050 and the costs of achieving this may bring about equity market re-rating or revaluation of companies within their sectors and relative to their benchmark.

- Equity markets may look for superior transition scoring relative to the industry whilst equity investors may look for this relative to their benchmarks.

Enhanced, as well as deep, analytical skill will be required to identify, assess and score potential outperformers as the global economy embarks on Climate transition.

Enabling Opportunities
A Subset of Climate Investing

Stocks with mitigation or enabling technologies have hitherto attracted the greatest attention where climate-related investment is concerned.

We believe only a subset of the market has climate-enabling or mitigation opportunities and we identify these to be mainly in Industrials, Materials and IT (Figure 2).

The winners will be those with proprietary technologies and strong barriers to entry. However, new technologies, new entrants, and new ways of investing in the next decade — for example public-private partnerships — make a longer-term assessment of future competitive positioning more difficult.

Portfolio concentration in a few sectors will also entail greater risk. Valuation will depend in large part on the success of a firm's technologies with regards to climate resilience and should this become impaired for any reason, an abrupt loss of value in the name could result.

Hence, not only will these 'Opportunities'-type companies be assessed on their transition planning, but the future of their market positions will also be under the spotlight.

Figure 2
Promising Progress
Ahead of COP26, the World Has Made Progress Toward Net-Zero

Source: COP26 Private Finance Hub. Note: bn = billion; ESG = environmental, social, and governance; GFANZ = The Glasgow Financial Alliance for Net-Zero; NGFS = Network for Greening the Financial System; TCFD = Task Force on Climate-Related Financial Disclosures; trn = trillion.

Figure 3

Climate-Related Investment: New Strategies Take Shape

	Strategy Inclusion Criteria	Valuation Drivers
Climate Transition Strategies	• Future climate transition plans' credibility to be assessed and scored. • Credibility of management in achieving net-zero emissions and how well their plan is quantified. • Strong scores for future climate transition plans determine portfolio inclusion.	• Stock valuation re-rating/de-rating dependent on credibility of transition plan. • Fund is diversified relative to benchmark.
Climate Opportunities Strategies	• Climate solutions objective but with scoring for transition. • Company owns proprietary climate-enabling or mitigation technology. • Concentration in a subset of industries which make up around 40% of the current MSCI ACWI benchmark.	• Valuation to reflect potential success of climate-resilience technologies and innovation. • New entrant risk including new technologies and new forms of financing and or partnerships makes sectors more cyclical and valued accordingly.

Source: State Street Global Advisors.

Conclusion

We observe that many of the publicly listed companies we look at already have well-thought through and credible net-zero emissions plans. Active equity managers will have to develop in-house proprietary strategies for assessing the credibility of climate transition planning.

Transition-oriented portfolios will provide the opportunity for strong portfolio diversification and this in turn will have the potential for delivering sustainable as well as healthy returns. In contrast, an 'Opportunities' strategy will be narrower in focus, more concentrated in sectors and the returns profile may not be as smooth.

Overall, as managers of global equity portfolios, we see great opportunity in this new era for forward-looking, in-depth research and bottom-up stock selection.

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