Insights

Environmental, Social & Governance (ESG)

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Why Climate Should Be Your ESG Priority

Jonathan Shead
Head of Investments, Australia

We believe climate change is one of the biggest risks in investment portfolios today — and one of the greatest opportunities. In this article, we outline why.

Climate Change is *the* ESG issue

Numerous academic studies suggest that Environmental, Social and Governance considerations are material to both risk and return for investors.[1] But good ESG ratings are complex to build; important issues for one industry may be irrelevant for another industry.[2] So, out of all the ESG issues you could consider, why do we believe climate change is so important? Because there is no other ESG issue that matches climate for the size of the required global response and the clear linkage to financial outcomes via carbon pricing.

1. **A Global Response is Inevitable**

The science behind climate change is largely settled, and the consequences of an uncontrolled increase in global temperatures are widely believed to be severe. The world faces a choice on *how* we respond to climate change, not *whether* we respond. The world can choose to respond now or be forced to respond later, however respond we must.[3] That means there will be consequences for capital markets and investors whatever track our planet takes.

While the digital revolution has dramatically changed how much of the world works, this revolution was voluntary, driven by industrial and personal preferences and by productivity improvements. It also occurred over many decades. The changes required due to climate change are arguably greater than the digital revolution, but they are not optional, and the time frame required is relatively short.

While it is arguable the global response has been too slow to date, there is growing momentum for major change. Net-zero emissions announcements from governments have picked up pace; some 73% of global emissions are now covered by target announcements including the US and China.[4] Over 2,000 companies have joined the United Nation's (UN) "Race to Zero" campaign[5] while the Net-Zero Asset Owners Alliance now covers US$5.7 trillion in assets[6] and the Net-Zero Asset Managers initiative has 87 signatories with US$37 trillion in assets under management.[7]

2. A Global Response Will Have Clear Financial Opportunities and Costs

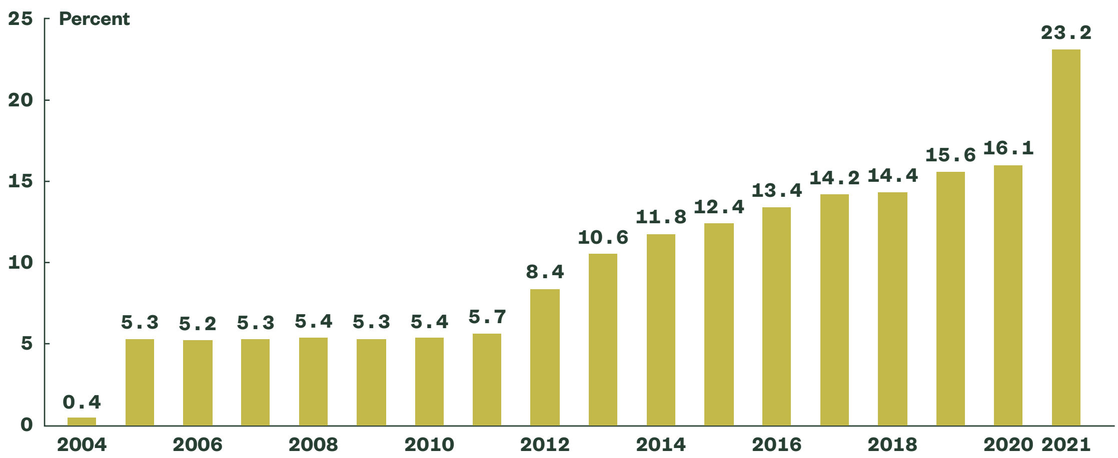
But how does global momentum for change convert into economic outcomes; into *financial* opportunities and costs? Attaching a price to Green House Gas (GHG) emissions is critical if we are to achieve the changes necessary to alter projected climate outcomes. There are two main approaches to providing price-based incentives to reduce GHG emissions:

- **Carbon Tax** A tax rate on GHG emissions or on the carbon content of fossil fuels. With a carbon tax, the price on carbon is defined but the level of resulting emissions reduction is undefined.

- **Emissions Trading Scheme (ETS)** An ETS first caps total GHG emissions and then establishes a market price for emissions. High emitters can buy allowances from low emitters and low emitters can sell their extra allowances to larger emitters. The level of emissions reduction is defined but the price on carbon is undefined.

Carbon pricing has already been adopted in many parts of the world. In fact, there are currently 64 carbon pricing initiatives either implemented or scheduled to be implemented around the globe. The level of carbon emissions covered by these schemes continues to grow, with carbon tracker estimating over 22% of global GHG emissions being covered.[8] World Bank data shows how coverage of GHG emissions has grown rapidly in the last 10 years.

Figure 1
Share of Global GHG Emissions Covered by Carbon Pricing Initiatives



Source: World Bank Carbon Pricing Dashboard as of 16 May 2021.

But carbon pricing coverage is only half the story. Not only do we expect the coverage to continue to expand, we also expect the average price attached to carbon emissions to increase. Without any changes in how fossil fuels are used within the global economy, this expansion in coverage combined with rising emission prices has the *potential* to push total costs as high as 12% of global earnings.[9]

However, we live with dynamic capital markets that respond to challenges and incentives. As the *potential* impact of carbon pricing expands, we believe this will accelerate the development and adoption of new technologies and processes.

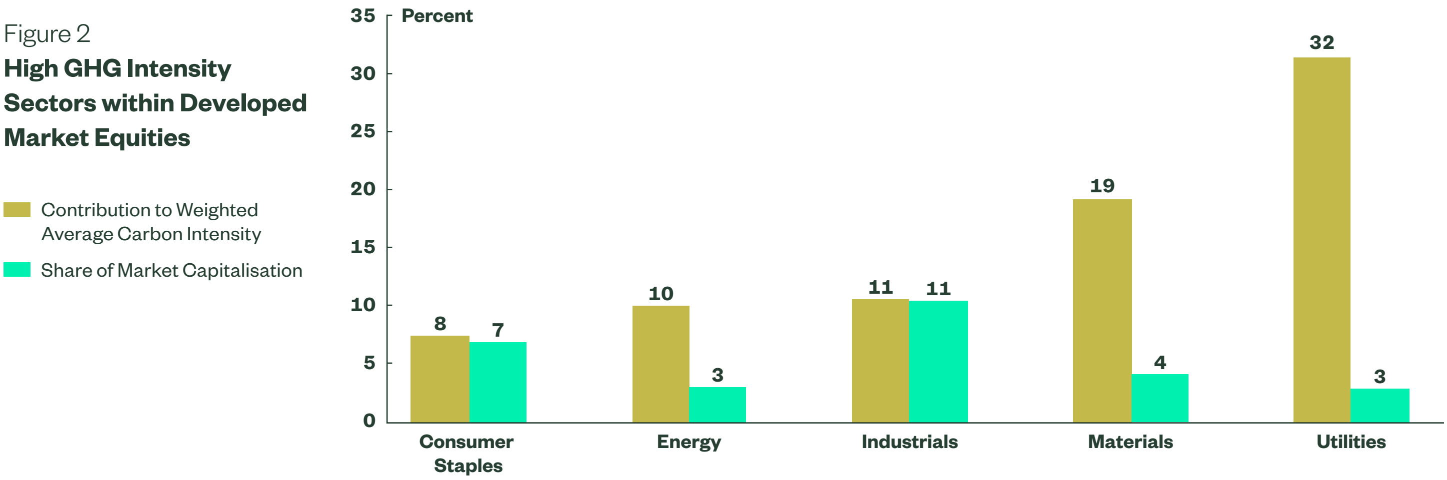
3. **The Costs are Spread Widely Across Companies, Industries and Countries**

Unlike some ESG issues, the risks and costs associated with climate change are clearly *systemic*. Financial markets need to digest and react to the impacts on economic growth and mass changes in energy infrastructure. Furthermore, while financial markets have often focused on fossil fuel energy generation, managing climate change is about much more than just solar panels. Land management in the face of climate change involves challenges in desertification, land degradation, sustainable land management and food security. Similar challenges from changes in the ocean and cryosphere (i.e. frozen regions) threaten not only communities close to the coast but communities inland through extreme weather events. Financial markets need to be prepared for potentially significant societal disruption as well as economic changes.

Risks, costs and opportunities also vary across *countries*. Not only do petro-states need to reinvent themselves in time, but other countries will race to develop leadership in new technologies and renewable energy sources.

The impact on *corporates* of climate change mitigation and adaptation varies greatly. Key industries like Electric Utilities and Multi-Utilities in the Utilities Sector and Integrated Oil & Gas in the Energy Sector, contribute disproportionately to GHG emissions. The Utilities sector only makes up 3% of developed equity market capitalisation, and yet contributes 32% of the developed market emissions intensity. The Materials and Energy sector also make significant contributions to GHG emissions intensity despite only being 4% and 3% of developed equity market capitalisation, respectively.

Figure 2
High GHG Intensity Sectors within Developed Market Equities



Source: State Street Global Advisors, S&P Trucost, MSCI as of 31 March 2021. Shows contributions to Weighted Average Carbon Intensity for MSCI World using S&P Trucost Direct and First Tier Indirect GHG emissions data.

Clearly, there are companies in the Utilities, Energy and Materials sectors that are particularly vulnerable to climate-related industrial change. However, it is also true that these highly visible impacts are easier for financials markets to evaluate than more complex downstream impacts in seemingly unrelated industries. To pick a random example, what are the consequences for delivery of fresh seafood in the restaurant sector?

Finally, there are specific risks to *asset valuations*. Proven fossil fuel reserves are only of value where they can be extracted and burned. If they can no longer be used, they lose their value and become "stranded assets". The value at risk for stranded fossil fuel assets has been estimated as high as US$25 trillion.[10]

4. **The Opportunities are Huge**

Any discussion of climate that focusses solely on costs misses the opportunities associated with a transformation of the global economy. Global costs of low-carbon electricity generation are falling and are increasingly below the costs of conventional fossil fuel generation. Renewable energy costs continue to decrease and are now competitive with fossil fuel-based electricity generation in many countries.[11]

But opportunities from this transformation extend well beyond the allocation of capital to proven renewable energy solutions. Further innovation is required, and with this comes further opportunity.

> **“The International Energy Agency warns that 42 of 46 critical clean energy technologies aren’t on track. And roughly half of the carbon emissions reductions needed for a swift net-zero transition will need to come from energy technologies that have not even reached commercial markets yet.”**
>
> — John Kerry, Special Presidential Envoy for Climate[12]

What Does This Mean for Clients and Their Portfolios?

1. **Climate Change is a Market Wide Rather than Stock Specific Issue**

   Some ESG issues are of special relevance to companies in particular industries. For example, “Access and Affordability” is a key sustainability issue for parts of the Health Care sector, while “Materials Sourcing and Efficiency” is a key issue in much of the Food and Beverages sector.[13] However, the impact of climate change is so pervasive that it needs to be treated as a market-wide issue for investors rather than a stock specific one.

2. **Climate Objectives can be Captured in Well-diversified Core Holdings**

   We believe that picking climate change “winners” and avoiding “losers” in small speculative portfolios will be both difficult to achieve and insufficient to meet the investment challenge in the years ahead. A market-wide challenge like climate requires subtle adjustments to core portfolio holdings.

   We believe investors should be lowering their overall exposure to carbon emissions, while still maintaining some exposure to key global sectors like Utilities, Energy, and Materials. They should be reducing their portfolio’s exposure to fossil fuel assets that may lose their value. They should be tilting their core holdings towards a broad spectrum of emerging “green” opportunities. These include companies in energy generation, environmental resources, food and agriculture, transport solutions, waste and pollution control, and water infrastructure and technology.

   Many of these adjustments require complex trade-offs. For example, how should investors treat companies in the Utilities sector who are high carbon emitters, but who are also investing heavily in low-carbon technologies? The complex adjustments needed to cater for the risks and opportunities from climate change are well suited to well-diversified core portfolios.

3. **Strategies Need to Adapt as Climate Science and Data Evolves**

   One of the key ingredients to the rapid growth of ESG investing has been the emerging availability of data across key sustainability issues. Climate data is no exception, with the Task Force on Climate-Related Financial Disclosures (TCFD) playing a key role.[14] Nearly 60% of the world's 100 largest public companies support the TCFD, report in line with the TCFD recommendations, or both.[15] However new data will continue to emerge as both climate science and capital markets evolve. A core equity portfolio needs to be adaptable; able to incorporate new data and new portfolio management techniques to meet the climate challenge.

Climate change may be *the* ESG investment issue of our time, but there are robust ways in which investors can respond in their core portfolios.

Endnotes

1 "Corporate Sustainability: First Evidence on Materiality", Khan, Serafeim, Yoon (2016)
From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance, March 2015, University of Oxford and Arabesque Partners.

2 The Sustainability Accounting Standards Board (SASB) lists 26 broad sustainability-related business issues ranging from Customer Privacy to Air Quality to Business Ethics. Obvious climate related issues only account for 2 of these 26 issues; GHG Emissions and preparation for the physical impacts of Climate Change.

3 Source: IPCC. For those looking to get an idea of the potential outcomes the IPCC describes three possible warmer worlds; late uncoordinated action, delayed but decisive action and early, effective action. See https://ipcc.ch/static/infographic/worlds-apart/.

4 Source: Climate Action Tracker. See https://climateactiontracker.org/.

5 Source: Race To Zero. See https://racetozero.unfccc.int/.

6 Source: UNPRI. See https://unepfi.org/net-zero-alliance/.

7 Source: Net Zero Asset Managers Initiative.

8 Source: The World Bank. See https://carbonpricingdashboard.worldbank.org/.

9 Source: State Street Global Advisors. "Carbon Pricing: Where are We Going?", Carlo M. Funk, Nathalie Wallace, September 2020.

10 Source: Carbon Tracker. "Fossil fuels will peak in the 2020s as renewables supply all growth in energy demand, September 2018."

11 IEA (2020), *Projected Costs of Generating Electricity 2020*, IEA, Paris.

12 Source: U.S. Embassy & Consulates. Remarks at the Keynote Session of B20 2021 Inception Meeting. See https://fr.usembassy.gov/remarks-at-the-keynote-session-of-b20-2021-inception-meeting/.

13 Source: SASB. See https://materiality.sasb.org/.

14 The TCFD was created by the Financial Stability Board, which is an international body that monitors and makes recommendations about the global financial system.

15 Task Force on Climate-related Financial Disclosures 2020 Status Report, October 2020.

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