Briefing

There is more than one C in ESG

RISK | PENSIONS | **INVESTMENT** | INSURANCE

Spoiler alert: the C has nothing to do with the coronavirus.

Remember earlier this year when the ‘lockdown’ for many of us in the Northern Hemisphere was self-imposed and caused by endless days of rain, whilst for those in Australia it was drought and bushfires causing the problem? Remember when we spent 2019 telling you that ESG was actually three different elements: environmental, social and governance? We stressed that E had more elements to it than simply climate change. Times have changed.

Our message last year was that each of these risks can be managed and could improve the’ bang for our buck’ through better risk-adjusted returns.

Fast forward to 2020. The landscape has materially changed in the last six months. The Government has squarely stated that a large part of the responsibility for dealing with climate change rests with asset owners. Unsurprisingly this has seen 2020 dominated by ‘C’: climate change – or, more accurately, climate risk.

Consider the quote below from Charles Counsell, Chief Executive of The Pensions Regulator:

> “Climate change is no longer simply a social responsibility issue. It is a core financial risk impacting broadly across business, the economy and markets. Climate change is a risk to long-term sustainability that pension trustees need to consider when setting and implementing investment strategy.”

Climate change is emotive. Some believe, some do not. Some see it as being influenced by humanity, others see it as a natural phenomenon.

Very important point: when it comes to investment, your own beliefs do not matter. If others believe it will have an impact and are changing what they do, the price of assets will change, and you will be affected.

Another very important point: although the rise in global temperature creeps up slowly, its impact on asset values is already starting to have an effect, and the momentum behind this is increasing.

And another one: The temperature shift associated with the MSCI World Equity Index is around 3.7 degrees Celsius. Can your portfolio perform under the changing economic conditions that will result from this?

The reason to read on: do not think of this as an issue which only affects equities. The impact of climate change is already being felt in the bond, property, commodity and infrastructure markets as well as equity markets.

For the reasons above we view climate change as a risk. We believe that, like interest rate and inflation risk, it should be managed.

In this note we provide some more background on the impact of climate risk and discuss ways in which that risk may be managed.

If you invest using a passive or index-tracking approach to investment management, there may be a temptation to view this as an issue for others and, heaven forbid, stop reading here. Let us explain why this is not the case. Firstly, there is always an active decision that needs to be made when selecting which index to track. This is no different if you want to manage climate risk and still follow an index-tracking approach. An active decision on which index to track – including maintaining the status quo – needs to be made.

Before going into this in more detail it is worth reiterating that despite the recent shift in emphasis we have not changed our views on the wider issues of ESG. We believe they continue to represent risk factors that will impact investment returns and you should manage these alongside climate risk.

Finally, before we deep-dive into the main topic of this note, the new UK Stewardship Code will see investment managers having to disclose their voting records, which in turn should help trustees be better placed to help address their own, wider, disclosure requirements relating to ESG. We will soon be covering this in a separate note on stewardship.

What are my investment managers doing about ESG and climate risk?

In general, your active managers should always have been alert to these sort of issues – they are risk factors to generating returns. We think the market environment has changed over the past five years and so, for reasons such as reputational risk, the market is reacting more severely/quickly to such issues than has historically been the case.

We expect the impact of this to be more stock level volatility. For active managers the need to be on top of these issues is greater now than it has been in the past.

From a practical standpoint, we see a wide range of competencies from active managers in factoring these risks into their thinking. When assessing the conviction, we have an investment manager in to deliver their long-term investment targets, we consider the manager's competency in this area – we believe it is becoming a bigger factor in market pricing and so are increasing the weighting we are placing on it, compared to what we would have done in the past. We see a big dispersion on the extent that active managers embrace climate risk and some downgrades in manager ratings may be forthcoming.

An active manager's approach to climate risk can fall into one of the categories below:

1. They have always done this to a reasonable extent but not called it as such. The changes they are making are aimed at more explicitly and clearly communicating their approach to investors.
2. They have done a bit in the past but recognise the need to raise their game and adopt a more formal policy in relation to it, reflecting the growing importance of this risk factor. We are very mindful of the need for clients to understand the difference between what a manager says they have been doing and the reality of what they have been doing.
3. They have never paid much heed to it but are now saying they do. From a long-term return perspective, this is the most dangerous position from a client perspective. You are lead to believe that your manager is taking account of climate risk, when in actual fact they are merely paying it lip service. Greenwashing – as it is called – is a reality. This is the approach we are most concerned by and of which we are most likely to downgrade managers as a result.
4. They just don't care. We see many examples of this and the "geography" of the manager seems to play quite a crucial role. European managers, in general, do not fall into this category, given this has been an issue their clients/investors have long been concerned with. However, we do find that investment managers with a US heritage are far further behind and more frequently display these traits.

BARNETT WADDINGHAM
beyond the expected

Views on climate change

The Paris Agreement is seeking to limit the impact of climate change to +2 degrees Celsius. An important point for passive investors in particular is that the benchmarks currently used to provide a guide for many asset managers (or to be tracked in the case of a passive investor) are not compatible with this end goal. We discuss why and how you can address this below.

Mark Carney, Governor of the Bank of England, said in December 2019:

> If you add up the policies of all companies out there, they are consistent with warming of 3.7 – 3.8 degrees".

This is supported by academic research. The key points he made were that this was far above what people say they want and what governments around the world are demanding. This takes us back to our opening "very important point": the investments that you are holding will be impacted by investors' behaviours and changes to government policies whether you agree with it or not.

Scientists have associated a 4 degree temperature shift with a 9m rise in sea level. For comparison, the Palace of Westminster is 8m above sea level.

Of far more significance is the impact that such a rise would have on the rice bowls of Africa and Asia, both in terms of the populations they support and the populations displaced as a result. Estimates are that a 9m rise in sea level would see as many as 760 million people displaced globally. When we reflect on the political changes in Europe caused by the arrival of hundreds of thousands of migrants from Syria, rather than hundreds of millions, it is clear rising sea levels present a risk to political stability.

This is not to suggest these things will happen – but even if they happen at a fraction of this level, it would have a very significant impact on the assets that you hold.

Donald Trump may be well known for his 'prophets of doom' quote in relation to climate change. However, it would be wrong to view the US as not being engaged or taking steps as a result. California (which has the world's fifth largest economy) has committed to being 100% use of zero carbon electricity by 2045. California Governor Jerry Brown then signed an executive order committing California to total, economy-wide carbon neutrality by 2045. This goes beyond electricity (which makes up 16% of California's carbon emissions) to include the other 84% too.

Caution: this is not the same as they have changed the law to do this. It should be viewed as a direction of travel that policy eventually might follow. Other states have also made commitments on renewable energy and carbon emissions. The disruptive impact on companies of such a far-reaching commitment, as that from California, will inevitably lead to greater volatility in markets.

Closer to home, TPR has been in communication with the largest schemes in the UK asking them what they are doing to combat climate risk.

At the same time the government has committed to consulting in the summer on regulations to make reporting climate-related risks a requirement for larger schemes. A cross-industry group supported by DWP and TPR have produced guidance for trustees on assessing, managing and reporting climate-related risks in line with the Taskforce on Climate-Related Financial Disclosures (TCFD). We can work with clients to start to get ahead of this coming regulation and have been closely involved in producing the guidance.

The expectation is that this will eventually become compulsory for all pension schemes.

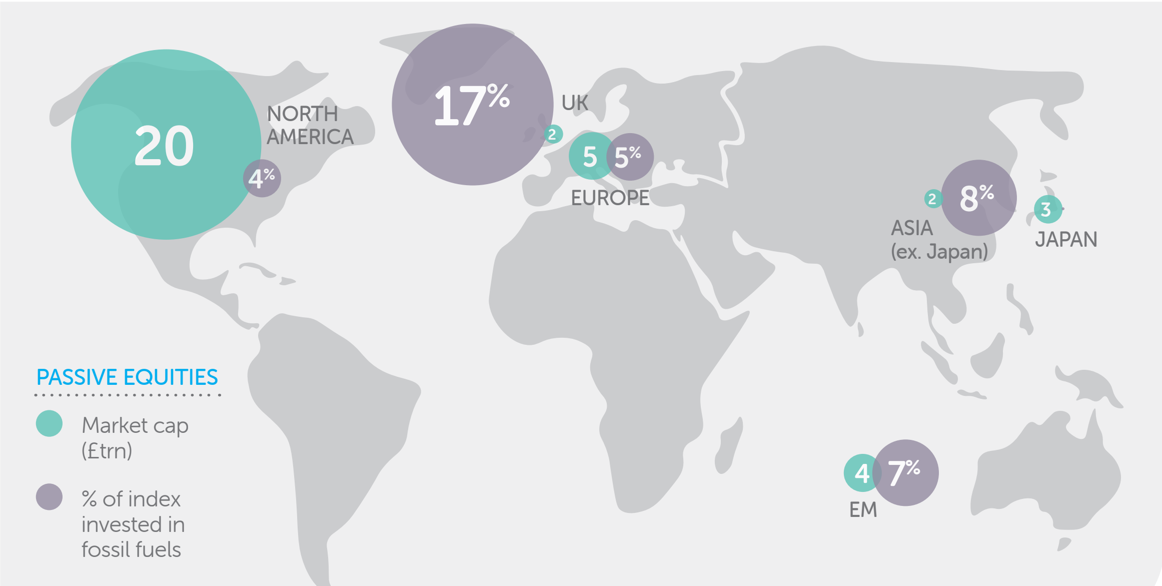
Guy Opperman, Minister for Pensions and Financial Inclusion, 2020:

> "I am committed to ensuring all pension scheme trustees do everything they can to act to limit the risk climate change poses to their members' future retirement income.
>
> "TCFD is the most widely-adopted way in which organisations are managing and reporting climate risk, and I want to ensure all trustees have the help they need to align their schemes with its recommendations. That is why I welcome this guidance.'

What should I be thinking about?

We have set out in the section above what we expect investment managers to be doing on your behalf. We now turn to what we think you as asset owners should be considering.

We start from an equity standpoint and note that it is important to understand that not all stock markets are equal from this measure. To illustrate this we show a comparison of the world stock markets by value, and hence the typical weighting they would be held within a passive global portfolio, with a comparison by fossil fuel exposure (a rudimentary carbon measure).



Source: Barnett Waddingham

For UK pension scheme investors with UK liabilities, a home bias in our equity allocations is relatively common, albeit to a lesser extent than in the past. This is often true for other UK investors as well. However, the heavy weighting to the oil and gas sector in the FTSE All-Share Index results in this leading to portfolios that are more exposed to climate risk than those with less UK focus.

Within markets it is also important to understand that not all sectors are equal. From a climate risk perspective the market can be thought of as having low stake sectors – such as medicine, healthcare, insurance and telecoms and high stake sectors – such as oil and gas, energy, transportation and agriculture. The latter being carbon intensive sectors that have a high climate risk attached to them.

When managing climate risk, you need to decide whether you:

- want to try and minimise your exposure to it – in effect, overweight the low stake sectors – but recognise at the same time you are not helping to bring it under control
- maintain an exposure – perhaps reduced – in the high stakes sectors, recognising that the need to be part of the energy transition is key and presents opportunities as well as threats

In future notes we will be discussing this in more detail. Managing climate risk is not a static decision, it is not a single decision. It must take into account the pace of change in the market, the tools available to mitigate risk and the impact of government policy – not to mention the attitude of TPR. Add to this the delivery of government policy to meet announced commitments, like the end of sales of internal combustion engines by 2032 and net zero emissions by 2050, and it becomes clear an ongoing monitoring approach is needed.

Similar considerations apply in other assets to equities. Again, using our rudimentary carbon measure of exposure to the fossil fuel industry, we can see very different exposures across different sectors of the credit markets and equity markets:

5%	6%	1%
GLOBAL EQUITIES	INVESTMENT GRADE CREDIT	LOANS - EUROPEAN

3%	12%
LOANS - US	US HY

Source: LGIM, Janus Henderson, Barings

What is clear is that a methodology for measuring a portfolio's impact on climate is needed. Paris Agreement Capital Transition Assessment (PACTA) helps investors implement the recommendations of TCFD. Its use should help bring much needed consistency to the measurement of portfolio impact. Crucially, it provides a more accessible measure of climate impact, in that results can be related to the Paris Agreement and are aligned with recent comments from Guy Opperman, the Pensions Minister: 'Paris alignment [is] a more compelling way schemes can measure and report their climate risk'

As we highlight above, the first step is to consider your exposure to this risk and then assess whether you feel this is an exposure to risk you are comfortable with. If not, what could you do about it?

For now, we set out three different approaches for schemes wishing to start managing their climate risk more closely or are looking to move onto the front foot and seek opportunities to mitigate climate risk in their investments.

1. **Basic or early steps approach:**
    - Consider reducing your exposure to more fossil fuel intensive markets, such as the UK equity market in favour of a more global approach
    - Look carefully at your bond allocation and your manager and what their attitude to climate risk is – 6% of the global investment grade market is fossil fuel related

2. **Moving onto the front foot:**
    - Review the indices you are either tracking or benchmarking your investment manager against
    - Understand their characteristics and where the climate risks lie within them.
    - Consider moving to an approach that sees index construction based on a more carbon aware framework
    - Consider investments that supplement these that seek to capitalise on global energy transition from fossil fuel to greener alternatives

3. **Deeply embedding climate risk management and seeking opportunities for positive impact:**
    - Start to look beyond just the carbon usage of the companies invested in. By mapping the portfolio using PACTA, the emphasis is on realigning portfolios to a temperature difference that creates a positive impact, e.g. 1.5 degrees. In doing so, the focus falls on firms with a positive carbon management story, e.g. electric vehicles, insulation firms etc
    - Consider bond management that avoids lending to traditional fossil fuel companies, unless for 'green' purposes
    - Consider the use of impact based investment funds and support efforts to positively address climate risk through your allocation of capital

What should you be doing?

An important point to note is that the developments within the investment management market mean that these approaches are rapidly becoming available for all pension schemes. Even a few years ago, if a pooled fund investor wished to consider any of the above issues, it would have been impossible. Now however, size is no longer a prohibiting factor.

As we referenced earlier, investment managers are rapidly evolving how they tackle this issue and therefore investors should be:

1. Considering their exposure to this risk
2. Ensure, at a minimum, that they are not unintentionally exposed to a greater degree than necessary (for example, due to a large UK Equity weighting)
3. Consider how best to implement their strategy in relation to this risk

Finally, it is worth noting that investment manager actions are not always positive. Care therefore needs to be taken to consider what is under the bonnet of a fund. The headline, or fund name, is rarely sufficient to understand what is being held – inclusion of the word "sustainable" means very different things to different funds. To be continued...

WHAT OPPORTUNITIES DOES THIS CREATE?

Economic growth and energy usage are very highly correlated. To maintain economic growth in the long-term, it will be necessary to manage the energy transition from fossil fuel to renewable. This transition is already underway. However, the pace of change needs to increase if carbon emission targets – and, with them, climate change targets – are to be met. Opportunities to enhance return by participating in this transition already exist.

Moving to a 100% renewable energy target requires the ability to have 'dispatchable' rather than 'variable' power sources. Renewable energy is currently variable, i.e. it mainly relies on wind and sun, meaning it cannot be turned on or off at will. To achieve a 'dispatchable' energy supply where the power is generated using renewable sources will require energy storage. Cost effective renewable energy storage is not yet available. Companies that can achieve it will grow rapidly.

It needs to be recognised that many of the companies involved at the forefront of these technologies are still small and fall outside of the typical market indices that are used at present. If these opportunities are to be exploited then a more focussed or impact approach on them is needed. In our next note on climate risk we will be addressing this in more detail.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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