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Climate change: The major questions facing investors

BY JOLANDA DE GROOT

The physical risks of climate change and the long-term transition to a zero carbon global economy have enormous implications for the investment community. Scenario analysis is an essential tool for managing the risks and identifying the opportunities. Financial Investigator spoke with Peter in de Rijp, Head of Distribution Netherlands, and Eva Cairns, Senior ESG Investment Analyst, both working at Aberdeen Standard Investments (ASI).

How can institutional investors implement climate change into an investment portfolio? Where do they start and what is the basis to have in place?

Eva Cairns: 'Climate change is one of the defining issues of our age. Its physical manifestations are negatively affecting ecosystems, human health and economic infrastructure. The transition to a zero-carbon economy presents significant challenges, but also opportunities for investors. To properly account for these risks and opportunities we have developed a unique approach to climate-scenario analysis. It allows us to assess the financial impact on assets today of different climate pathways, ranging from a 1.5°C to a 4°C rise in global temperature.

This provides the forward-looking insight we need in order to robustly incorporate climate change risks and opportunities into our investment decision-making. We are embedding our insights into our business strategy, investment processes and the development of climate-driven solutions for our clients. In doing so, we believe we can build more resilient portfolios and generate better long-term returns for clients. Importantly, we believe climate-scenario analysis is a journey rather than a one-off project. We intend to update our analysis annually.'

Is there a role for asset managers to play in orienting investors to align their portfolios in a more climate-aligned way? And if so, in what way and how?

Peter in de Rijp: 'We think asset managers have an invaluable role to play. However, our goal is not to instruct, but to inform and engage where possible. Let's return to our climate scenario analysis. Through this, we aim to help investors understand how physical climate change and the energy transition affect the investment returns of the companies and markets in which they invest.

Our rigorous approach helps us generate a detailed picture of what the energy sector might look like in the future. This includes the potential winners and losers within sectors. Take solar power as an example. Even in our worst-case scenario, solar's share of the power sector's energy mix doubles to 4% by 2050. This increases to 25% in our mean scenario and to almost 60% in some strict-action scenarios. Armed with this type of analysis investors might be able to make more informed choices about their own portfolios.'

To what extent should institutional investors like pension funds play a role in aligning their portfolios to climate targets?

Cairns: 'We think climate change and the march towards net zero will be one of the defining issues of the next few decades. Despite this, we are still seeing a major shortfall in the capital aligned to meet these challenges. According to the International Energy Agency, the world needs to immediately allocate around $ 3.5 trillion a year to finance the decarbonisation of the global energy system at the speed and scale implied by the Paris Agreement. Currently, the world is allocating only around half of that. This is why we believe asset owners like pension funds and insurance companies have a vital role to play. Given the substantial capital available, they can help tackle the issues by increasingly aligning their portfolios to Paris-led initiatives. At ASI, we are committed to playing a constructive role in the decarbonisation of the global economy and to enabling our clients to reach their net zero goals. That's why we have recently joined the Net Zero Asset Manager initiative. We are developing net zero solutions and will work with current and prospective clients to outline how net zero goals can be delivered alongside risk-adjusted returns.'

Why are climate change scenario's important for the daily work of an asset manager?

Cairns: 'Driving our approach to climate-scenario analysis is the view that a forward-looking rigorous and transparent methodology is essential for sound investment decision-making. We are fully integrating our climate scenario framework and insights into our business strategy, as well as into the key stages of our investment process.

At the stock level, we can integrate the results into active stock selection. We do so by asking critical climate-related research questions that are informed by our scenario analysis. Our answers will complement our broader company research, including our assessment of the credibility of firms' transition strategies. This in turn will allow us to construct portfolios that are resilient to different, plausible climate pathways. We will also fully integrate climate risk and opportunity into our Strategic Asset Allocation framework.

We are also embedding scenario analysis into our approach to stewardship. Where we identify material climate risk, we will engage with companies to understand what actions they are taking to mitigate them. We also encourage firms to undertake their own analysis. It helps businesses understand the resilience of their business strategy to different climate pathways. It is also a core part of the Task Force on Climate related Financial Disclosures (TCFD) framework, something we strongly support.'

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CV

Eva Cairns is a Senior ESG Investment Analyst at Aberdeen Standard Investments who is responsible for leading ASI's climate change strategy, delivering climate change research and ensuring climate change considerations, data and tools are embedded consistently across ASI's investment processes.

Should a climate impact analysis become a regulatory requirement for an annual report similar to a P&L account and a balance sheet?

Cairns: 'Ideally, yes. As it stands, reporting and measuring the impacts of climate change still have some way to go. Disclosure is particularly challenging when it comes to private investments and value chain emissions (so-called Scope 3 emission). However, as a whole, this is starting to change. So much so that we hope that one day reporting on climate change will be seen as 'business as usual', similar to a P&L account. There are reasons for optimism. After all, only a decade ago ESG reporting was in its infancy. Now, a large number of companies include ESG reporting as standard. The IFRS, for example, published documentation in 2020 on how to incorporate material climate change considerations into financial accounts.

Government initiatives could also help in this regard. In the EU, for example, the Non-Financial Reporting Directive means large EU 'public interest' corporates must publish data on the impact their activities have on ESG factors. Similar reporting measures specific to climate change could follow.

We too strive to improve how we measure and report. We are strong supporters of the TCFD framework, which provides best practice on how companies should disclose on climate-related risks and opportunities. TCFD will become mandatory in the UK by 2025 – the second country to do so after New Zealand. We published our first TCFD report in March 2021 and the second one is in progress.'

Is the private sector doing enough to meet climate ambitions? And what is the recourse for those falling behind?

Cairns: 'It will take time for companies to transition towards net zero – and some sectors will find this a lot harder than others, such as long-range transportation, energy and heavy industry. These industries will still be needed in the future and require capital to transition. In our view, investing in transition leaders with credible decarbonisation strategies has more of an impact on achieving net zero in the real world than divesting from these companies to have a low portfolio carbon footprint.

We cannot expect firms to become climate neutral overnight. Indeed, we recently spoke with a company that has a high carbon footprint but that wants to change. Whilst making this transition, it will still have to fulfil is daily obligations to its clients, staff and shareholders. However, it has signalled its goals and started to make the necessary changes. Any punitive measures at this stage would be misguided. We therefore believe that governments, policymakers and investors need to work with companies as they adapt and change course.'

To what extent are questions around climate implications becoming part of RFPs to asset managers?

In de Rijp: 'We have certainly seen a marked increase in climate-related questions. This is not surprising. Recently, we worked with Danish research firm Kirstein to gauge Dutch asset owners' views on ESG and impact investing. When asked which of the SDGs was most important, the answer was clear – Goal 13 (Climate Action).

We are also seeing this trend reflected in the RFI/RFP questions we receive. For example, in recent RFI, under the subsection entitled 'Planet', we were asked: 'Have you implemented or do you intend to implement a lower carbon Global Credit IG Strategy? If yes, explain your approach and share your CO_2 reduction target.'

Now, the RFI was for a global ESG credit mandate. However, the above question clearly shows that the asset owner is already thinking about the next stage of its investment journey.'

Are you already managing portfolios for institutional investors with an explicit climate related target?

In de Rijp: 'We currently manage a global credit mandate for a large pension fund. Pitched in 2020, we were given two explicit targets: a carbon footprint that is at least 30% lower than the benchmark, and a fairly low tracking error, which was a requirement from the pension fund. Based on in-depth portfolio analysis, we were able to meet both targets. The result is a portfolio of around 410 issues from a universe of some 12,800. The average portfolio credit rating is the same as the benchmark (A-). So, you get the benefit of a lower carbon footprint without having to compromise on risk or expected return.

Using our climate scenario analysis, we are also currently developing a number of climate-driven products to support the energy transition and meet investors' climate goals. These include a multi-asset climate fund, a global equities climate and environment fund and a credit climate-transition bond fund. Not all solutions will fit for everybody as investors have a different set of objectives. We want to provide a variety of solutions that all contribute to a lower carbon world.'

Is an explicit climate related target going to reduce expected returns? How can we measure and evaluate success?

In de Rijp: 'We believe the opposite is true, as we've shown with the Global Credit example. We are developing climate-driven client solutions that not only deliver financial outcomes, but also contribute towards meeting the goals of the Paris Agreement.

Another good example of climate-focused strategy is the climate-tilted benchmark. Most investors gain exposure to equities and other asset classes using standard benchmarks like MSCI World or FTSE 100. These indices may either be tracked by passive index funds or used as the benchmark for active managers. To manage climate risk or move to net-zero portfolios, one important method that investors are exploring is to replace these benchmarks with low-carbon, high-climate-solution alternatives.

When making this switch, investors generally aim to ensure that climate-tilted benchmarks demonstrate similar financial characteristics to their standard equivalents. To do this, we employ portfolio-optimisation tools that use historical security-level returns and correlation data to generate portfolios with low deviation in returns, or 'tracking error', relative to the standard index, but with substantial improvements to carbon performance.

We have found that it is possible to achieve large tilts away from carbon-intensive companies towards climate-transition leaders (as measured by SBTI) and climate solutions while maintaining very similar sector exposures and within a tracking-error budget of 50 basis points.' «


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CV

Peter in de Rijp is Head of Distribution Netherlands at Aberdeen Standard Investments. In this role he is responsible for the institutional and wholesale business development in the Netherlands. He has been working in the Dutch investment market since 1988 and has considerable knowledge and experience in the Dutch institutional sector. He joined the company in October 2015. Previous employers are SEI Investments, Fortis Investments Netherlands, Achmea Investment Management and the Dutch Treasury. In de Rijp holds a Master Degree in Monetary Economics from the University of Tilburg.