Climate change investing: net zero considerations

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Paul LaCoursiere, Global Head of ESG Investments, explores key considerations related to climate investing and the path to net zero.

Key takeaways:

- *Climate change requires immediate action, but we believe there may be unintended consequences of certain approaches that could be underappreciated.*
- *Capital markets and asset managers have a clear role to play in the transition to net zero and should be coupled with strong action at a government policy and taxation level if intended outcomes are to be delivered.*
- *Net zero commitments could have trade-offs at an individual portfolio level and it is important these are well understood.*

Climate change poses a real and present danger to the world around us, and we believe the time to act is now. The evidence is compelling:

- The planet's average surface temperature has risen 2.12 degrees Fahrenheit / 1.18 degrees Celsius since the late 19th century.
- Most of the warming occurred in the past 40 years, with the seven most recent years being the warmest.
- The years 2016 and 2020 are tied for the warmest year on record.
- Global sea levels have risen by around 8 inches / 20 centimetres in the last century. The rate in the last two decades, however, is nearly double that of the last century and accelerating slightly every year.[1]

We believe the investment industry has an important role to play to try to slow global warming and facilitate the move to the net zero carbon emissions target by 2050 as adopted in the United Nations Paris Agreement of 2015. We also believe incorporating Environmental, Social and Governance (ESG) factors, including climate risk, into investment analysis is a key consideration impacting risk-adjusted returns.

But when it comes to climate change, is there a danger of the investment community misdirecting its efforts? How, for example, with clients prioritising climate change risks in different ways, should asset managers commit to certain targets or exclusions? Should the responsibility to drive change lie with capital markets or politicians? And which questions should investors be asking asset managers to ensure objectives align?

The Paris Agreement and net zero by 2050[2]

The Paris Agreement is a legally binding international treaty on climate change. It was adopted by 196 parties at COP21 in Paris, in December 2015 and entered into force in November 2016.

Its goal is to limit global warming to well below 2, preferably to 1.5 degrees Celsius, compared to pre-industrial levels.

To achieve this long-term temperature goal, countries aim to reach global peaking of greenhouse gas (GHG) emissions as soon as possible to achieve a climate neutral world by 2050.

The role of financial markets in decarbonising the economy

With the ever-strengthening focus on how companies address ESG issues and an acknowledgement of the necessary changes, net zero targets are increasingly being signed up to. By 2030, the path to net zero could drive total annual energy investment to US$5 trillion according to the International Energy Agency, potentially adding an extra 0.4 percentage points a year to global GDP growth[3]. This scenario would see a sharp rise in private and government spending and create millions of jobs in clean energy as well as in associated engineering, manufacturing and construction industries. However, investors should be mindful that it is unclear whether the carbon transition will be a net contributor to growth. The scenarios outlined above have significant implications for capital markets.

The intention is that capital will flow towards those companies enabling carbon neutrality and away from those that aren't, thus pushing companies to act in appropriate ways and accelerating the carbon transition. The beneficiaries could be companies with low carbon footprints using or producing clean energy and other climate solutions. They could also be high emission companies that have a credible carbon transition strategy and are on improving trajectories. Conversely, capital should be directed away from laggards or 'bad' companies with no credible strategy to transition.

We believe the net zero goal is hugely important and a positive step forward as a tangible target to work to when it comes to addressing climate change. We recognise, however, that there are potential challenges and unintended consequences that will need to be accounted for. One example can be seen within the context of oil and gas. If laggard oil and gas publicly listed companies see their values fall sharply, there are an array of alternative capital providers eager to take advantage of heavily discounted assets. The new private equity or state-owned enterprise (SOE) owners may then seek to operate the assets at a higher capacity. This would lead to an increase in emissions rather than the hoped-for decrease.

Other challenges will be how to decide which are 'good' and 'bad' companies – with so many complex issues tied in with the transition, who and on what basis are these kinds of decisions made by asset allocators? Also, what are the potential collateral impacts faced by communities or economies (tied to the 'S' of ESG) which rely heavily on employment in, or revenue from, high emission sectors. Many industries also face natural limits on their ability to reduce emissions, given the extractive nature of their operations or reliance on fossil fuel, so it is currently unclear how meaningful offsetting options will be provided by government or future technologies. These challenges should not deter the global carbon transition but will need to addressed.

A need for political and policy action

The scale of the challenge requires, in our view, a co-ordinated response incorporating both capital markets and political policy. Capital markets alone will not be able to drive the scale of change required. If policymakers fail to shape the demand for fossil fuel and fundamentally force a change in behaviour, the impact will be muted. We believe politicians and regulators therefore have a responsibility for enforcing change and altering public behaviour. There is limited value in solving much of the financing side of the equation only to fail due to differences in national laws that are vulnerable to regional regulatory arbitrage. This would leave the potential for companies to take advantage of differences in policy between regions.

For politicians, however, directing attention towards capital markets is easier than explaining to an electorate the higher cost to society of a lower carbon economy. We believe asset managers have a key role to play but, as noted later in the paper, we would particularly like to see tax policy changes, which, in our view, are by far the most efficient and effective way to facilitate the transition. In short, we believe capital markets on their own will be unlikely to get the world to net zero by 2050. It is only with a co-ordinated policymaker response globally, combined with the already underway redirection of asset flows, that the goal becomes realistic.

Asset managers – instrumental to the change

In this two-pronged model, asset managers, of course, play an important role. At Janus Henderson, we believe an active rather than passive approach to investing is essential to influencing the complex and nuanced factors around climate change. The multi-dimensional analysis, selective investment and direct engagement practices of an active approach are, in our view, key to directing flows in the right direction and delivering the risk-adjusted returns our clients seek.

But with different asset managers taking different approaches to ESG, how should investors assess which to partner with? Key questions may include:

- How is climate change policy implemented to allow for the different ways that clients view the risks and the most appropriate solutions?
- What importance should be placed on the number of affiliations signed up to by the asset manager with ESG-related organisations and industry bodies? Which are the most important?
- How should investors judge an asset manager's progress towards its commitments? Should it be based on voting and engagement records, or reporting and data, and if so, which datasets tell an accurate story? Or something else entirely?

At Janus Henderson many clients have committed to net zero targets, and we are hugely supportive of these initiatives and excited to be working towards their delivery.

Equally, we recognise that among clients which do embrace the causes of, and problems posed by, climate change, each one may prioritise that risk differently against the broader spectrum. For example, an investor may prioritise a Just Transition (a framework to ensure the transition towards a climate-neutral economy happens in a fair way securing workers' rights and livelihoods) over the pace of transition. This would mean they would want to see government programmes in place to support re-education, employment transfer and land use policies before they would support a specific carbon transition timeline or approach. The different ways to approach the challenge, in our view, support the need for an active investment approach that allows strategies to be tailored or selected to accurately suit a client's objectives.

Balancing commitments with client needs

The thinking extends to our approach to date to carbon neutral policies at a portfolio level. As a firm, we are firmly committed to tackling climate change and are proud to have been CarbonNeutral® since 2007[4]. In addition, we have been a member of the UK Sustainable Investment Forum since 1991 and an investor signatory of the Carbon Disclosure Project since 2000. We are also a signatory or affiliated with: Climate Action 100+, the European Sustainable Investment Forum, the Global Impact Investing Network, the Institutional Investors Group on Climate Change, the Task Force on Climate-related Financial Disclosure and a founding signatory of the UN Principles for Responsible Investment in 2006. Our Global Sustainable Equity Team is one of the pioneers of sustainable investing, celebrating its 30th anniversary in 2021.

However, to date, we have refrained from applying a blanket carbon neutral approach to our investment portfolios. As an asset manager, we believe that doing so would effectively be making a decision on behalf of all the clients for whom we manage money and across all portfolios. This is potentially ahead of the decision being taken by clients and could conflict with a client's policies.

As an investment manager, we believe it is right that we can and do influence the firms in which we invest. We do not however believe we should direct this influence towards our clients, and we should not determine investment policies and mission statements on their behalf. Instead, we believe our role is to ensure our investment teams have the ability, resources, and information to meet our client's objectives, be they based upon return, risk, or climate.

For those clients who want to apply climate-based or climate-aware investment strategies, we have a wide range of options available and are delighted to tailor approaches to meet specific needs.

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Assessing the different approaches

Certain approaches of asset managers would, on paper, appear to merit ticks in the climate box. But they may not always ultimately deliver the intended results. We believe it is important to be aware of the challenges.

1. Divestment and exclusions

Divesting or excluding businesses that exhibit significant climate risk today comes with trade-offs.

Arguably, 'greening' a portfolio tends to reduce its level of market risk. This is because greener companies tend to exhibit higher earnings quality with lower leverage and lower earnings volatility, making them less susceptible to moves in the market.

This can, in certain situations, be beneficial to investors. However, market risk and expected return are related and some investors need market risk to achieve their return targets and meet their financial goals and potential liabilities. As a result, there could be an impact on return expectations of portfolios. This is, of course, fine providing it is appreciated by the investor.

In addition, as referenced previously, divesting from oil and gas companies or facilitating change that sees companies selling their oilfields to private equity or SOEs to achieve their carbon targets, will not, as the situation stands today, in all likelihood reduce oil-related emissions as long as demand remains unchanged. Blanket exclusions in this area would also remove capital from 'best in class' high emitters which are actively transitioning. It is potentially better to engage with these companies rather than exclude or divest.

2. Targets and commitments

Measuring progress towards net zero commitments requires reliable data. The datasets related to climate risk are currently not complete and rely heavily on estimation and projections. This is a limitation not always widely appreciated.

While data is improving in terms of availability and quality – new regulation across industries is helping – many companies at present still do not disclose basic climate metrics, such as carbon emissions. This means that data providers fill these gaps with industry averages or revenue breakdown-based regressions. This results in significant amounts of estimation bringing obvious challenges for investment analysis and decisions. The data issue is one that needs to be resolved with the risk that inaccuracies could subject a portfolio to unnecessary future turnover and trading costs.

3. Client appropriateness

As noted, it is important to ascertain if a blanket application of net zero targets across all portfolios is appropriate. There may be potential issues with adopting emissions targets, engagement, and voting/escalation requirements irrespective of who the client is. It is obviously essential to align expectations and ensure any shift in approach is appropriate to existing Investment Management Agreements.

Carbon transition – challenges and potential solutions

As noted above, we see meaningful challenges of relying on capital markets on their own to meet the necessary objectives. We also believe a focus on the reduction of GHG emissions is necessary, not just getting to net zero. The 'net' target may allow countries and companies to 'game the system' by continuing to pollute while finding other methods to reduce their carbon footprint. This may need to be addressed at a regulatory level.

We also recognise that there are many hurdles. Recently, for example, the Biden administration's efforts to phase out subsidies to the fossil fuel industry hit a setback. In August 2021, a legal ruling forced a resumption of auctions, with the government required by law to offer acreage to the oil and gas industry.

Risks to poorer countries from the carbon transition are also not always fully appreciated. Oxfam's 'Tightening the Net'[5] report raised concerns about the swathes of land in low-income countries required to offset emissions through forestry. The report warned that reforesting land in poor countries would come at the cost of an explosion in demand for land and a sharp rise in food prices which, if not subject to careful safeguards, might risk increasing hunger and fuelling land inequality.

One approach that we believe would make a meaningful difference, as noted above, is the introduction of a carbon pricing system based on taxes. This would need to be sufficiently high to incentivise companies to move away from fossil fuels and make decarbonising economically viable. Within this tax system, the government would set the price required to pay for every tonne of GHG emissions that a business produces on goods and services that are GHG intensive. The aim would be for consumers and businesses to embrace change and use new technology or cleaner energy to reduce their carbon tax bill.

Carbon taxes would also raise finances for governments to channel to green initiatives. However, administrations will need to carefully consider how these policies may impact the consumer, given firms will pass on the costs, and any detrimental effect on different income groups. Only a transition that is 'fair' to all groups would seem to be a viable proposition that could be sold to voters. Linked to this model would be the development of carbon financial markets to allow carbon credit trading. This would aim to reduce GHG/carbon emissions cost-effectively by setting limits on emissions and enabling the trading of emission units to facilitate, and accelerate, progress.

Conclusion

At Janus Henderson, we are committed to promoting environmental sustainability and are proud to have a strong heritage of involvement with carefully selected sustainability-related organisations and initiatives.

We firmly believe in the important role asset managers play in tackling climate change and seek to always balance this with the responsibilities we have to our clients. A key aspect of this is flagging potential issues and working towards solutions. We aim to continue to evolve our commitment and offer the range of tools, analysis and strategies that best meet desired client and societal outcomes on the path ahead.

References

[1]NASA https://climate.nasa.gov/evidence/
[2]United Nations https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement
[3]International Energy Agency https://www.iea.org/news/pathway-to-critical-and-formidable-goal-of-net-zero-emissions-by-2050-is-narrow-but-brings-huge-benefits
[4]CarbonNeutral® certification applies to Janus Henderson Investors since 2017 and Henderson Global Investors prior to this date.
[5]Oxfam Tightening the net: Net zero climate targets - implications for land and food equity

IMPORTANT INFORMATION

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