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Measurement Matters

Improved assessment of carbon impact could spur ESG investment and drive innovation.

Key takeaways:

- Investors are increasingly being encouraged to measure their carbon impact and allocate funds to low-carbon investments
- Adding exposure to companies that offer solutions to the challenges of climate change could be a source of additional value
- Existing strategies aimed at carbon reduction include equity and green bond strategies

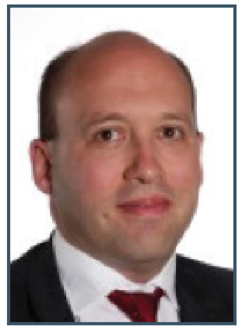
It is instinctive to embrace familiarity and reject change. This, at least in part, explains why many investors feel comfortable with portfolios that contain household names, such as the global energy giants.

Investors feel less comfortable creating portfolios that incorporate ESG (Environmental, Social and Governance) factors - which typically exclude the oil majors - even though many investors acknowledge that **ignoring ESG factors poses risks to a long-term portfolio.**

These risks include “stranded” or “frozen assets” – the risk that energy companies will not be able to exploit the reserves which form a key part of their enterprise valuations.

While more and more investors are asking their asset managers about how they integrate ESG factors into portfolios, still only about 10% of institutional assets are selected according to ESG criteria.

Maybe this is because sustainability and decarbonisation are relatively new investment concepts, or maybe it is because most portfolios are measured against traditional benchmarks. Most likely it is a combination of the two.



Jens Peers, CFA

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Whatever the reason, **decarbonisation is gathering momentum and investors are increasingly being encouraged or coerced into allocating to low-carbon investments.**

Why should investors care about decarbonising?

It is now widely acknowledged among developed and developing nations alike that energy transition is inevitable and necessary. The tide of history is flowing in one direction only, propelled by global climate change agreements such as COP 21, signed in Paris in late 2015, and by initiatives such as The Portfolio Decarbonization Coalition or the Montreal Carbon Pledge. **These and other initiatives push firms to trim their carbon footprint and encourage investors to embrace decarbonising investments.** In particular, COP 21 demands a substantial change in the global energy mix to keep the global temperature rise below +2°C.

National and regional regulation to bolster this ambition can be expected.

For the investor, this means there will be a cost to holding carbon-intensive assets in their portfolios. In France, for instance, investors already operate under a comply-or-explain regime for their carbon footprint. European-wide rules are at some stage probably imposing compliance on millions of retail and institutional investors.

Amid this shift, **investors are increasingly seeking to measure their carbon impact**. Effective measurement can be an end in itself – once you start measuring something, you start to consider it more deeply and this focus can change behaviour. It is not dissimilar to the attitudes of homeowners before and after they fit water meters. After fitting one, most homeowners are more prudent in their use of water.

Measurement will lead investors to new opportunities too. Companies that are able to reduce their carbon footprint and, more importantly, help to provide solutions to a high-carbon world, should create long-term value.

Not all decarbonising strategies are made equal

But measurement of carbon emissions is not a simple exercise, and techniques have not yet reached maturity across the investment industry. Some measurement methodologies - and by extension some ESG strategies - bypass important components of carbon output measurement.

To explain, most strategies incorporate what is termed **"Scope 1"** measurements, which relate to the carbon emissions that companies directly produce during their core business activities. Data on these emissions is readily available and so are widely used by measurement specialists and the investors they serve.

"Scope 2" relates to the emissions from the inputs to the business activities. This focuses primarily on electricity consumption, and relevant data is similarly widely available.

However, most companies and investors overlook **"Scope 3".** This focuses on emissions from the use of the product and supply chain and are neither measured nor employed in most ESG strategies, despite the fact they can represent the majority of the total carbon footprint of the product. In car production, for instance, **Scope 3 emissions are more than 80% of the total. So only by including Scope 3 emissions can you really start to measure the true carbon footprint of a company, and of a portfolio of companies[1]** .

Transparency can result in unintended consequences

Considering the emissions of end users as well as of companies is a major step forward in measuring an investment portfolio's carbon footprint. But it's still not the whole story.

Regulation and voluntary disclosure is pushing investors to publish their carbon impact and this is driving transparency of investment strategies. Signatories of the 2014 Montreal Carbon Pledge, for instance, disclose their carbon footprint so policymakers and investors can make more informed decisions.

However, while transparency is to be welcomed, it can have unintended consequences. Investors now have an incentive to disinvest from carbon-intensive businesses and invest in (close to) zero emissions companies. This can be positive, but not always. You might, for instance, see a fund manager sell a holding in wind turbines - which require carbon inputs to manufacture - and buy a stake in a software company, which has practically zero emissions. The portfolio now scores higher in carbon ratings, but the net effect for the environment is negative because, over the long term, wind turbines have a substantial decarbonising impact. Therefore, beyond Scope 1, 2 and 3 emissions, it is also important to take into account if a company helps to avoid CO2 emissions compared to a reference scenario: not only green technologies do not emit CO2, they also help to avoid CO2 emissions compared to traditional fossil based energies. A portfolio which seeks positive decarbonisation must allocate to companies that offer solutions to the problems people and the environment face. **We think it is better to add exposure to companies that meet the challenges of climate change rather than simply financing low-carbon companies.**

Making a difference

How can investors add exposure to solutions providers?

The most obvious way is by **investing in technologies that aim to arrest the depletion of natural resources, such as renewable energies**, where the costs of construction are falling rapidly as subsidies are tapered.

But there are other mega-trends which are putting pressure on communities and environments, the solution to which throws up significant investment opportunities. These mega-trends include world population growth, urbanisation, the growth of the middle classes in emerging markets and ageing populations. All these trends lead to greater carbon intensity.

Solutions include technologies that increase building efficiency, such as the light-emitting diode (LED), insulation innovation, efficient heat pumps and smart controls. Meanwhile, in transport, we expect to see the emergence of more and better electric and hybrid vehicles.

In the energy industry, smart grids are likely to proliferate. In fact, most industrial sectors will innovate to some extent in order to decarbonise.

A choice of decarbonising investment vehicles

Carbon-reducing strategies can be expressed through a number of investment structures and vehicles. One common perception of ESG is it is applied through negative screening of a large universe of stocks. Certainly, it is possible to construct a global equity portfolio with a low-carbon impact. **But rather than simply filtering out low ESG performance, we prefer an approach that engages with portfolio companies to improve their ESG rating.** Mirova's large team of sector-specialist analysts have an engagement remit which enables them to communicate with companies about carbon reduction. With $6.5bn in assets under management, Mirova has attracted more than $60bn in third-party engagement assets.

A dedicated equity strategy, focusing on enabling technologies, such as those mentioned earlier, can create still further value.

The enabling technologies theme can also be exploited through investment in infrastructure, such as **wind farms, solar energy, hydroelectricity and biomass**. The US, in particular, is spending significantly on its energy infrastructure as it adapts from being an energy exporter to an importer.

It may surprise some investors to know that **bonds can also facilitate solutions to the carbon challenge**. Green bonds, in addition to the usual bond characteristics of maturity and coupon, are **designed to finance projects that offer specific environmental benefits**. Because of the constraints on issuers of green bonds, there is precision and transparency over the use of the proceeds.

While green bonds are still an immature asset class, there is now some $60bn in issue, compared with less than $5bn just five years ago.

What kinds of investors can benefit from decarbonising?

For some investors, decarbonisation is seen as a niche strategy, akin to allocating to alternative investments. In fact, it can be incorporated across the portfolio and should be considered a core investment. It is based on broad markets, with tracking errors of 3%-5% to the chosen benchmark and many of the stocks can be found (albeit in different proportions) in traditional portfolios.

Decarbonised portfolios are surprisingly well balanced across themes, sectors and countries. The key difference is they take advantage of ESG trends and manage those risks differently to most investment strategies. In Mirova's case, these risks are managed differently not only to traditional managers, but also to most of its peers in the ESG sector. **With a highly-concentrated portfolio of about 50 stocks, Mirova aims to outperform a given index by 2%-4% a year.**

For institutional investors, a decarbonised equity portfolio is a natural substitute for, or complement to, a core sector-based or geographically-diversified equity allocation.

Equally, green bonds can form part of an institution's core global bond portfolio. Returns are determined by the credit rating of the issuer, so investors receive a similar rate of return - for a given issuer – as for any other bond. For institutional investors which are signatories to UNPRI and other ESG codes, their standing among beneficiaries and policymakers can be enhanced by investing in green bonds because they are financing environmental transformation, while achieving market yields and greater transparency.

[1] Find out more about Mirova's methodology on http://www.mirova.com/Content/Documents/Mirova/publications/va/studies/MIROVA_Study_Measure_Carbon_Impact_Methodology_EN.pdf

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