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Responsible Investment: From niche to mainstream

Ophélie Mortier **explains the importance of integrating all three elements of ESG (environmental, social and governance) into investment processes**

WRITTEN BY OPHÉLIE MORTIER, RESPONSIBLE INVESTMENT STRATEGIST

Responsible or sustainable investment continues to grow significantly. The integration of ESG (environmental, social, governance) criteria into investment processes is definitely going mainstream. We consider this an integral part of our fiduciary duty as stewards of our clients' funds.

An increasing number of asset managers, including DPAM, are convinced that integrating ESG criteria is not an option, but a must these days. After all, it is not only about optimising the risk-reward of a portfolio, but also about excluding or mitigating certain risks. To name but a few, extreme natural events, large-scale forced immigration due to climate change, data protection and security, terrorist attacks…

These challenges reinforce our convictions about responsible investment being more than just a fad, and that we should integrate all three dimensions (E, S and G) into investment processes.

E = Environment

An economic challenge

The United States has pulled out of the Paris agreement because it sees it as a millstone around the neck of economic growth and full employment. However, its gross domestic product is set to decline by an estimated 1.2 per cent for every additional 1°C temperature rise. Under the Obama administration, the Pentagon had stated that climate change posed a risk to national security. Indeed, many Americans live near the coasts and a massive exodus to the centre of the country would have major consequences on social cohesion and the US economy.

The same problem crops up on a global scale. According to estimates by the International Organization for Migration, 20 million people were displaced and became refugees as a result of climate change in 2016. By 2050 this figure will rise to 250 million, presenting a major challenge to the countries accommodating the immigrants.

Industries that have been particularly hard hit:
Economically speaking, sectors like energy and transportation bear the brunt of this major challenge. Between 2015 and 2016, investments made in the oil and gas sector dropped by 26 per cent, amounting to nearly $650 billion.

Conventional electricity generation (gas, coal and nuclear) in Europe faces a major challenge due to global warming. Indeed, the water required to cool the power plants is becoming increasingly scarce. In 2030, it will need to reduce generation or stop it completely as there will be no fresh water available any more. There are solutions, but they entail significant investments to make cooling processes compatible with salt water. On the other hand, there are also solutions in alternatives to traditional capacity, namely in renewable energy. This sector currently employs nearly 9.8 million people worldwide. In the past four years, employment in the wind and solar energy industry has doubled. The new capacity, which has been installed across the globe, is growing by 10 per cent annually while production costs are constantly falling.

The transition challenge:
Energy transition is a major endeavour across the globe. It is creating many jobs and requires massive resources and financing, all of which could be profitable to multiple sectors and economies. It is also seriously disrupting the way we think about the construction of investment portfolios. In the past few years, we have been witnessing an industrial revolution. It requires a new way of looking at the analysis of the sectors in

question and selecting solution providers. In our international equity strategy, this is just one of the several secular themes we take into account, besides electric vehicles, batteries and storage, clean tech, hydro, etc.

S = Social

Demographics and the challenges of an ageing population:

We are on the cusp of a real demographic turning point. First of all, this is related to an ageing population, and not only on the Old Continent. Furthermore, by 2050 there will be 9.1 billion mouths to feed. This means that food security will be more important than ever. Finally, generations Y (born after 1980) and Z (born after 2000) have already outnumbered the baby boomers in the United States. They have significantly altered the attitude and consumption patterns of previous generations.

The agri-food sector in the line of fire

The agri-food sector, which is the largest water consumer and a major emitter of greenhouse gases, is directly impacted by the challenges resulting from demographic growth, climate change and food security. Investors have a role to play here, which goes beyond the fight against food speculation. On the contrary, they should opt for solutions which tackle the availability, accessibility and appropriateness of food and by investing upstream in the production chain (infrastructure, logistics, equipment, seeds, etc.) We should think about producing better instead of producing more.

Boasting a solid track record of over 10 years in this sector, we focus our research efforts on these innovative companies, in line with the sustainable development goals of the United Nations, including the eradication of hunger and the promotion of sustainable agriculture (objective 2) while protecting our oceans, seas and marine resources and using them in a sustainable way (objective 14) and by preserving and restoring terrestrial ecosystems (objective 15).

G = Governance

Ethics and placing governance at the heart of the investment process:

States, companies and civil society currently face a democratic paradox: while social networks, referendums etc seem to reinforce the democratic process, in reality it is fairly constrained. Sound governance, for countries as well as companies, is the cornerstone of any sustainable social and environmental policy. It ensures stability and results in lower volatility of investments.

Democracy: A work in progress

According to the latest publications by Freedom House and the Democracy Index, political participation is growing. At the same time, however, democracy is in continuous decline. Just 4.5 per cent of the global population now lives in a full democracy, compared to 8.9 per cent in 2015.

The United States, that beacon of civil rights and liberties, is now considered as a flawed democracy as confidence in the functioning of its public institutions is sagging. The faltering confidence in institutions and political elites on the part of citizens can also be seen in Europe. It requires us to remain focused and vigilant. The democratic foundations ensure other fundamental rights are upheld. They guarantee social stability and a more stable investment climate. This is a major criterion in our proprietary sustainability ranking of OECD and emerging market countries. For instance, in the emerging market universe, non-democratic countries are excluded.

A new business model:

The same applies for companies. On the one hand, the company Snap, which created the Snapchat app, has blatantly violated fundamental shareholder rights. On the other hand, major oil companies have succumbed to the pressure of their shareholders. From now on, they will disclose their environmental policies and risk management programmes related to climate change.

As a matter of fact, Snap, which is the holding company of the most widely used app among generation Z (between 0 and 18 years old) has angered its investors by scrapping all voting rights attached to its public shares, under the pretext of maintaining a dynamic and flexible business model.

Business ethics:

Here too, our world is changing completely, and companies can no longer operate the way they used to. Business ethics will become increasingly important. On the one hand, regulation is heading in that direction. On the other, civil society and investors are becoming increasingly aware of the issue as business ethics may influence shareholders and global inequality. Whether the corporate world likes it or not, ethics is becoming de rigueur. At Degroof Petercam, we have fully understood this challenge and for us, sustainability is part and parcel of our corporate values. ■

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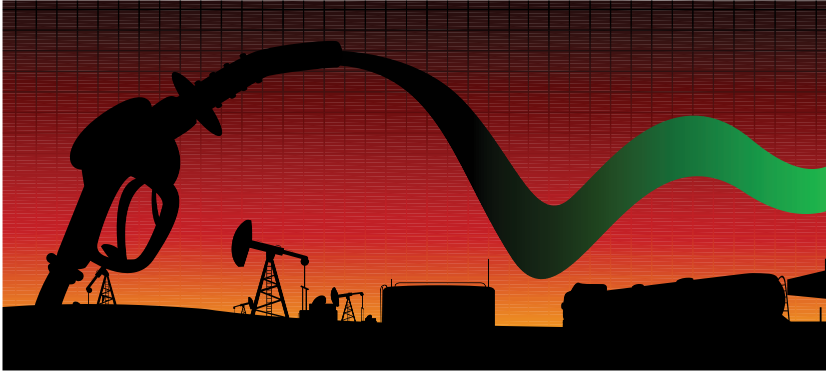

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Taking on the task

Elisabeth Jeffries **considers the impact the Task Force on Climate-Related Financial Disclosure initiative could have on ESG investors**

WRITTEN BY ELISABETH JEFFRIES

Had Exxon Mobil reported its oil reserves differently in 2016, investors might have altered their view of the company's future. It stated that its Kearl oil sands were reserves, and in 2016 was ordered to debook them by the US Securities and Exchange Commission. Systematically considering climate-related risk would have resulted in a different disclosure, a practice that could transform the perceptions of ESG investors allocating funding within the hydrocarbons sector.

"If the company were to integrate climate risk into its assessments, it would highlight that these assets show a high propensity to become impaired. They would have been downgraded to a resource rather than a reserve, and this problem would have been foreseen", notes CDP senior analyst Tarek Soliman. The non-profit is among several organisations promoting the adoption of recommendations from a new high-level initiative, the Task Force on Climate-Related Financial Disclosure (TCFD). This venture was established by the Financial Standards Board, an international body that monitors and makes recommendations about the global financial system, and is chaired by Bank of England Governor Mark Carney.

If they declared their annual results according to the Task Force's recommendations published in July, oil majors might steer their businesses towards a less carbon-intensive pathway. Reporting financial activity through the lens of climate-related risk would, according to the TCFD, help more appropriately price risks and allocate capital in the context of climate change. The initiative is voluntary, would help speed the transition to a low-carbon economy, and helps shift the corporate perspective beyond immediate concerns.

Most companies are not reporting on this basis. Disclosures of historic greenhouse gas emissions by hydrocarbons companies, an industry of key concern for ESG asset managers, has certainly improved since the last decade. These figures, usually expressed in tonnes of CO2 emitted, are often found in corporate responsibility statements. However, the pressure now exerted by the TCFD is to disclose for the first time in financial filings and to look far ahead into the future.

This is not about innovative accounting but more in-depth information. "It would change what the directors are telling us in the strategic report but wouldn't change [the structure of] the balance sheet and profit and loss account," explains TCFD special adviser and HSBC former chief accounting officer Russell Picot. For hydrocarbons, categories such as reserves and resources in strategic reports would be the numbers most likely to alter.

Leaders have already emerged, and the picture is mixed. In a 2016 study, *In the Pipeline*, CDP studied the hydrocarbon sector. It found Norwegian company Statoil the best hydrocarbons performer on carbon disclosure for the longer-term horizon, with Canadian company Suncor listed as the poorest, and Exxon Mobil last but one. "Statoil is the only company that quantifies what a world with a 2 degree Celsius [°C] temperature increase would do to its worth," says Soliman. Indeed, in its 2016 annual report, Statoil states that the International Energy Agency (IEA) '450 ppm scenario', compatible with that temperature increase, "could have a positive impact of approximately 6 per cent on Statoil's net present value compared to Statoil's internal planning assumptions as of December 2016."

Adopting TCFD recommendations

could increase the practice of carbon pricing in corporate reports - another way to express the risk of carbon regulation and to test the company's resilience in that light. Eight out of the 11 companies studied use an internal carbon price, ranging from USD 22/tonne to USD 57/tonne. Three (Chevron, Occidental and Petrobras) are silent on the matter.

According to Belgian asset management company DeGroof Petercam responsible investment strategist Ophelie Mortier, the Task Force provides "practical and concrete" assistance. Mortier considers that its recommendations to adopt carbon pricing to evaluate climate risk would make a significant difference to ESG investment research and decision making. But the inconsistences on carbon pricing need to be ironed out.

"Even though everyone agrees carbon is a risk, we don't have an agreed set carbon price per tonne. So I'm not sure everyone assessing investments can incorporate the carbon price, and do not know of analysts doing so," she says. As a result, some investment evaluations are not fully supported by appropriate information.

Mortier considers that scenario analysis, as advocated by the TCFD, would make an equally significant impact on DeGroof Petercam's work. The Task Force provides information on types of climate scenarios (produced by the IEA and others) alongside recommendations on the application of scenario analysis: a process for identifying and assessing a potential range of outcomes of future events (such as temperature increases of 2 degrees C) under conditions of uncertainty. From late 2017, the TCFD will also supply analytical tools and case studies to back up this activity.

Further help in this complex area would be quite useful, as Mortier suggests: "Scenario building is not at all easy to do," she says. "Only a few analysts have integrated this kind of scenario. They currently use Nationally Determined Contributions (NDCs) set following the UN Paris Agreement on climate change in 2015. But it's not easy to anticipate what countries a company will operate in," she observes.

A set of comparable sector scenario analysis would also assist investors. This could relate to a 2°C scenario as well as, for instance, scenarios related to NDCs and business-as-usual (greater than 2°C increase) scenarios. But the actual frameworks have yet to be shaped.

"We need to see a period of experimentation. Three or four years down the road we could potentially be assessing what is useful in the voluntary disclosures, and see it codified by institutions through, for example, stock exchange guidelines," says Picot.

Transition

The TCFD plays a significant role and comes at a time of transition. In the hydrocarbons industry, which makes a major impact on emissions, some oil and gas majors are considering climate risk, others are not. Some are acting accordingly, others paying lip service. One example of a directional shift is Italian company Eni, which is increasing the share of gas, a less polluting fuel, in its portfolio.

This industry differs from another carbon-intensive sector, the energy utilities, as Mortier points out. "For utilities, our sectoral analysis has seen a shift to low-carbon industries, and the shift has been integrated into utility investment. But our analysis shows oil and gas are a bit delayed on the shift to renewables", she says. Thus the TCFD data would provide major benefit for its investment teams, helping avoid investing in potential future stranded carbon-intensive assets.

If the corporate community systematically adopted the Task Force recommendations, balance sheet, income statements and strategic reports would need modifications. Picot points out: "Including climate risk would sharpen disclosures on the impairment of cashflows arising from assets."

But he suggested the most significant progression would be found in strategic discussions in financial statements. "This is not going to result in a huge data drop by companies but rather a thoughtful narrative description from board directors. It will hopefully be used as an engagement tool as well as a divestment tool," he says. A move towards less carbon-intensive business models could result. However, says Picot: "We're not saying they should alter their business model but that the information needs to get out there so that the market and the investment community can decide."

Disclosures on climate-related risk are improving but as the Statoil case demonstrates, the view of risk is always subjective. In 2015, Statoil assessed a 5 per cent loss in NPV, so the 6 per cent improvement estimated in 2016 demonstrated a u-turn in assumptions. Arguably, the risks to financial performance are considerable if a company moves away from its traditional business model or abandons its store of expertise. ESG investors will need to decide for themselves the extent of the climate risk to hydrocarbons companies. New data emerging as a result of the TCFD would mean they are better informed. ■

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