Responsible Investing

Stay the path: capturing climate transition opportunities

2022

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HIGHLIGHTED IN THIS PUBLICATION:

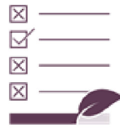
The ESG considerations contained in this document can change without notice.

The effects of climate change are becoming more and more apparent with the increasing reports of floods, storms, and fires around the globe. Biodiversity is declining and there is mounting pressure to not only discuss climate issues but to actually put words and promises into action.

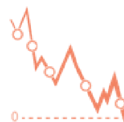
The climate transition

The climate transition is the shift to a Net-Zero future in order to reduce the risks of climate change. Under the Paris Agreement, which came into force in 2016, there is an international commitment to limiting global warming to well below 2°C, with the aim of bringing it down to 1.5°C by the end of the century. To remain within that temperature limit, greenhouse gas emissions need to reach Net-Zero by 2050. Net-Zero implies that the greenhouse gases being added to the atmosphere are balanced out by the volume of emissions being removed. There is, however, no guarantee that this target will be met, with projections based on current policies suggesting a temperature increase of 2.7°C above pre-industrial levels by 2100.[1] This represents an enormous challenge but the situation will only become more difficult, the longer things are left unchanged.

What is driving the climate transition?



One reason to act is changes in consumer behaviour. According to a survey by IPSOS, 69% of consumers globally have altered the products and services they use due to concerns about climate change.[2] It is notable that this is a global trend and not just a concern in the Western world. Since emerging market populations are most likely to experience the impacts of the loss of biodiversity, it makes sense that their behaviour is also changing.



Consumers are also holding companies accountable for their actions. We have already seen a number of companies pivoting and adapting their strategies in response. Now, an ever-increasing number of companies are setting ambitious climate targets: announcing goals to reduce their greenhouse gas emissions to Net-Zero by 2050 or before. To get there, we have seen automakers channel investment into electric vehicles, energy companies expanding their renewable energy capabilities and being less reliant on fossil fuels, and increasing carbon capture technologies in industry, amongst other measures.

We are potentially only a few years away from significantly more restrictive government regulations that may alter the way the economy works. As the reality and the risk of climate change becomes increasingly visible, it is inevitable that governments will be forced to act more decisively than they have done so in the past. The question is not whether they will act – but rather when. A "Minsky moment" might be upon us if action is not taken fast enough and on a large enough scale – meaning a sudden collapse in financial markets could lead to companies and the economy as a whole being forced to decarbonise. Adapting early may mitigate the risk of forced losses and increase our chances of capturing opportunities. The speed and coverage of regulatory developments related to sustainable finance are expected to keep growing and gaining in complexity.

Finally, the climate transition provides significant impetus for strong investment flows. According to the OECD, investment of more than USD 6.9 trillion a year is needed to meet the goals of the Paris Agreement, opening up many avenues for future returns. Companies that are slow to adapt could miss out on the first-mover advantage and even cease to exist.

The combination of strong scientific evidence, changes in consumer behaviour – especially in the younger generation, the willingness to improve the legacy of older generations plus corporate and regulatory changes are creating the backdrop for disruptive changes. This marks the beginning of a potentially strong megatrend.

Are we heading in the wrong direction?

There is an increasing number of companies making bolder commitments to reach Net-Zero targets. Setting out targets is a step in the right direction but how can we tell if there is any weight behind these often ambitious claims? Looking at current CO_2 emissions intensity pathways, it appears that the gap between the market's desired pathway to reach the targets of the Paris Agreement and the reality – based on current actions – is actually widening. Furthermore, the expected cost per unit of emissions is increasing. The estimated spot price of carbon emissions will top USD 300 per tonne of CO_2 by 2030 and exceed USD 650 by 2050. The increasing pathway gap and the rising unit cost of emissions is creating a growing carbon liability risk.

[1] Climateactiontracker.org/global/temperatures/
[2] Climate Change and Consumer behavior, IPSOS 2020

CLIMATE TRANSITION

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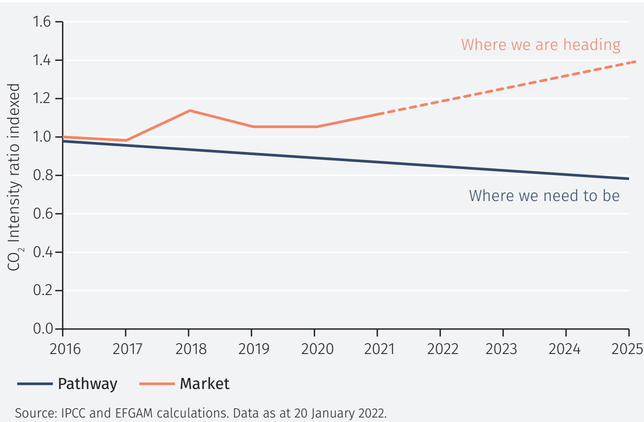
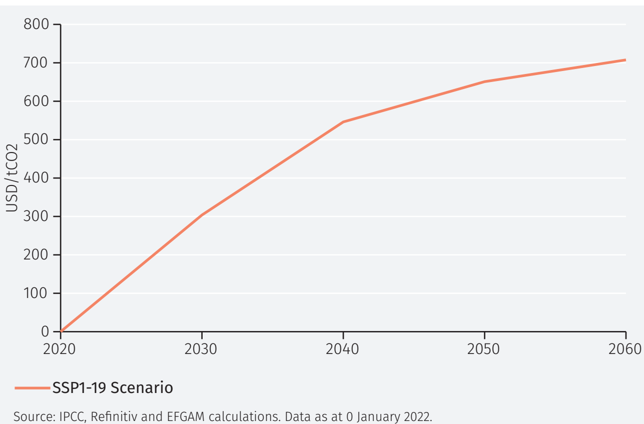
1. CO_2 emissions intensity pathways



Source: IPCC and EFGAM calculations. Data as at 20 January 2022.

2. Estimated spot price of carbon emissions



Source: IPCC, Refinitiv and EFGAM calculations. Data as at 0 January 2022.

Outside the broad market, there is often a trade-off between exposure to climate investments and protection against carbon risks. This would previously have demanded a combination of several offerings, ranging from thematic products to broad market investments, while still monitoring risk and exposure at an aggregated portfolio level. A more holistic approach looking at the bigger picture is more innovative and aims to leverage exposure to climate and transition opportunities across sectors while also protecting against carbon risk.

The Climate Engine

EFG already integrates environmental, social and governance (ESG) considerations into its investment research and strategies. Our GRIP (Global Responsible Investment Platform) was launched back in 2011 and since 2018 we have calculated CO_2 emissions for our funds, as adopting a measurement-based approach is the first step to improvement. From being a member of the main industry associations working to reduce emissions, we have gained substantial knowledge. We recognised that measuring emissions was not enough to improve our understanding of carbon risk in a portfolio context or to help us reduce the negative impact of those emissions. To broaden our analysis, a holistic view has been taken in the development of the framework.

EFG's Climate Engine has been designed to align the complete portfolio with decarbonisation goals. We evaluate thousands of companies and data points to determine the alignment because we believe that actions speak louder than words. While we actively incorporate targets announced by companies into the model, the backbone of the assessment lies in real data and real decarbonisation in contrast to many other models in the market. This systematic approach is scalable across sectors, market maturities and time-frames while also allowing us to keep a good factor exposure and achieve a high level of diversification of the product. Our approach allows us to reduce negative impacts, capturing all the opportunities without creating additional absolute or relative financial risks.

EFG defines a specific decarbonisation path for every company that is aligned with Sectoral Decarbonization Approach (SDA) projections. Our quantitative model compares this pathway with estimates of company emissions to see how closely they are actually aligned. This measures the actual performance of the companies rather than only trusting company targets, limiting the risk of greenwashing. The Climate Engine approach allows for the identification of companies that represent a low warming implied risk while avoiding those whose pathway is not consistent with climate change goals.

Conclusions

We are currently writing the history of tomorrow. We all know what we have to do to mitigate the negative effects of climate change. At the same time, regulatory, social and media pressure continues to support this megatrend which is expected to grow even stronger over the next decade. Ultimately, the climate transition is about transforming societies and economic systems. A failure to act could expose portfolios to both risks and missed opportunities.

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