

The Investment Implications of Climate Risk



This is the final paper in our three-part series on Climate Risk. In this article we consider how climate risk influences investment decisions, developing the topics discussed in our previous papers, “The Science of Climate Risk” and “The Societal Implications of Climate Risk”.

To establish and implement investment decisions based upon climate risk is undeniably an immense task. This does not make it impossible. We advocate an approach which applies tried and tested methods to a developing problem: building a framework to inform investment decision-making on climate risk. For us, this results in our preference towards companies with a lower

gross exposure to carbon emissions than the benchmark. This is the optimal outcome for our Cameron Hume Global ESG Fund. Many alternatives exist, and we would be pleased to work with our readers and clients to discuss an outcome directly suited to your needs.

A Global Issue

There is broad consensus that the greater the amount of greenhouse gases (GHGs) in the atmosphere, the more the global temperature is expected to rise. Further, reaching a global agreement on tackling GHG emissions is essential to successfully reducing the amount by which the temperature of the planet increases. Achieving that consensus has, so far, proved impossible, calling even a 2°C scenario into question¹.

According to CICERO, a climate research institute:

“Our assessment, based on the current climate policies and pledges, is that meeting a 2°C scenario is not the most probable scenario. The current pledges, if fully implemented, would lead to closer to 3°C warming by 2100, whereas business as usual with current policies would lead to even greater global warming.”

This is a challenge for investors. We must navigate a range of scenarios, taking into account a number of fluctuating variables, to produce the best long-term solution...with actions that need to be taken now.

Where Do Investors Start?

The Financial Stability Board has made it clear that financial market participants need to act. Its Task Force on Climate-related Financial Disclosures (TCFD) said in the Final Report on their recommendations in 2017:

“While it is widely recognized that continued emission of greenhouse gases will cause further warming of the planet and this warming could lead to damaging economic and social consequences, the exact timing and severity of physical effects are difficult to estimate. The large-scale and long-term nature of the problem makes it uniquely challenging, especially in the context of economic decision making. Accordingly, many organizations incorrectly perceive the implications of climate change to be long term and, therefore, not necessarily relevant to decisions made today.”

The TCFD exists to promote climate-related financial disclosure to support better management of climate risk, which must be an essential part of any investment manager’s risk framework.

Importantly, the TCFD recommends the implementation of tried and tested methods that financial market participants are already familiar with².

The key recommendations are reproduced in Figure 1, which guides our own framework and response to climate risk at Cameron Hume. We give our interpretation of the TCFD recommendations for our clients, the asset owners, and ourselves, the fixed income investment manager.



Figure 1

Source: TCFD

Core Elements of Recommended Climate-related Financial Disclosures

Governance

The organisation’s governance and climate-related risks and opportunities.

Strategy

The actual and potential impacts of climate-related risks and opportunities on the organisation’s businesses, strategy and financial planning.

Risk Management

The processes used by the organisation to identify, assess and manage climate-related risks.

Metrics and Targets

The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

¹ <https://www.cicero.oslo.no/en/about>

² <https://www.tcfhub.org/>

Governance

Climate policies promote understanding of the actual and potential impacts of climate-related risks – one of the objectives of the TCFD – by encouraging all stakeholders to engage. This engagement must be built into governance procedures: in the UK the Prudential Regulatory Authority has asked firms to have

‘fully embedded their approaches to managing climate-related financial risks by the end of 2021.’³

The documents that govern the Investment Management Agreements should reflect both parties’ mutual understanding of the client’s climate policy.

A climate policy can be defined in a number of ways:

- **Discursive:** requiring the asset manager to report on how they have reflected the risks and opportunities of climate change in the portfolio;

- **Exposure-based:** setting portfolio limits based on measures of climate exposure, such as carbon footprint or alignment with a transition scenario;
- **Exclusions:** excluding certain issuers, sectors, or groups of issuers whose exposure to a sector, region or specific climate risk exceeds a threshold; or
- **Alignment:** portfolio consists of issuers that have committed to reduce their GHG emissions in line with a specified transition scenario; or excludes issuers who have made no such commitment.

Each of these types of climate policy are possible today and they can be implemented in combination. Asset owners should be guided by the dictum ‘Trust but verify’ – working with their appointed managers to articulate and ultimately take on appropriate exposure to climate risk.

Strategy

When clients set out their climate policies there is an explicit expectation that portfolios will reflect the given policy and the manager’s active investment views. Therefore, portfolio reporting should demonstrate not only compliance with clients’ policies, but also identify the climate-affected investment decisions of the manager.

To achieve this, we must define what we mean by exposure to climate risk and how this is to be quantified. Quantifying exposures is a pre-requisite for a mutually informed discussion

of the risks and opportunities posed by climate risk – without them, any discussion of the risks and opportunities will be anecdotal, partial and one-sided. We believe this would lean too much on ‘trust’ and too little on ‘verify’.

One of the objectives of the TCFD is to improve the availability of data on issuers’ exposure to climate risk and the actions they are taking to mitigate those risks. This inherently means that the portfolio measures used now are imperfect. Strategic decisions must develop the ability to ‘verify’.

Risk Management

Our approach follows standard risk management practices: what is the gross risk; what actions are being taken to mitigate that risk; and what is the net risk after those actions?

Borrowing from credit modelling, the gross risk arising from a given scenario is a function of the probability of that scenario occurring and the loss incurred as a result⁴. Mitigating strategies may reduce either the probability of the scenario occurring or the amount of loss.

Consider an industrial company, which has large gross carbon emissions today, but is expected to have modest emissions in the future because it has committed to a reduction⁵. Until it was able to reduce its emissions, this company would be highly vulnerable to legislation that penalised heavy-emitters.

However, though often overlooked, a company’s gross risk depends on the likelihood of such legislation becoming a reality. The likelihood of countries penalising companies with large emissions is inevitably linked to that country’s general attitude to policies concerning climate change. This would make the short-term gross risk for the above company greater if it was based in Europe than North America, for example. Much rests on the path for future policy growth, which itself will likely be strongly influenced by the rising physical risks associated with climate change⁶.

It is also important to look at how likely the company is to be able to meet its commitment to reduce emissions. One indicator would be how well it manages its current commitments. Another

would be whether or not the company has made a public commitment to reducing emissions and whether or not that commitment is tied to a particular reduction, such as the Paris Agreement or a 1.5° scenario⁷.

On the other hand, the more demanding the emission reduction target, the greater the difficulty in achieving it. Making assumptions about the economic environment and the actions of competitors can also deliver significant contingent financing risks.

This example demonstrates that the impact of climate-related risks on a company depends on its current position, its transition path, the evolution of the local regulatory environment and the company management’s ability to deliver on the necessary business transformation.

We believe that the management of climate risk in fixed income portfolios is an add-on to existing risk management principles. Many of the questions one might ask about an issuer’s ability and willingness to meet its debt obligations are the same, but the ‘large-scale and long-term’ nature of the challenge merits a layered approach. This must span portfolio, sector and rating aggregates as well as individual issuers.

In all cases, risk management should promote an understanding of the nature of the portfolio exposures resulting from our clients’ policies and provide our clients with the means to challenge our active management of their portfolios.

³ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/managing-the-financial-risks-from-climate-change.pdf>

Metrics and Targets

In order to deliver upon the TFCF framework, we need to define what we mean by exposure to climate risk and to construct measures that quantify that exposure.

We believe that the data provided by the ESG services of, for example, FTSE-Russell, MSCI and Sustainalytics, provides the means to quantify the investment implications of climate risk. Although their assessments are largely qualitative, because they are produced by a transparent, standardised process, we can use them to provide a working definition and quantitative measure of exposure to climate risk. Equally, because they assign a scale to their assessments, we can use this scale to

stimulate discussion about the sources and materiality of a portfolio's exposure to climate risks. Likewise, the Transition Pathway Initiative, the 'Inevitable Policy Response' and the Science Based Targets Initiative (*per footnote 7*) all provide the means to consider some of the other aspects of transition risks.

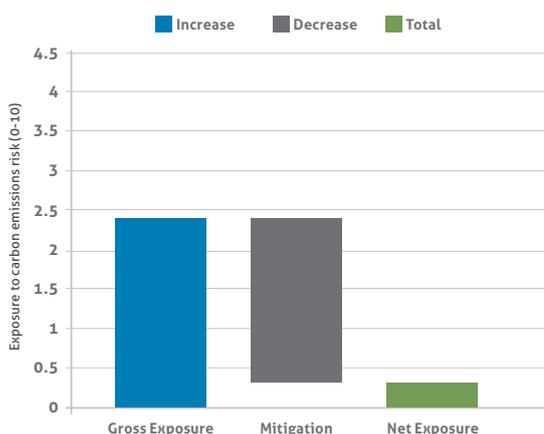
These measures may be imperfect and are an imprecise measure of climate risk and mitigation efforts, but they are nonetheless informative. As such they provide the basis for a discussion of the implications of the climate-related risks and opportunities in the portfolio.

Climate Risk Management in Practice

We conclude by returning to a real implementation of the example outlined above. Figure 2 shows measures of the gross and net exposures to carbon emissions for industrial companies held in the Cameron Hume Global Fixed Income ESG Fund and its benchmark. The ESG policy of this fund is to select issuers that Cameron Hume judges to manage their ESG risks better than their peers: there is no specific climate policy.

However, the resultant climate policy is revealed in Figure 2, which shows that the fund favours issuers with a lower gross exposure to carbon emissions than the benchmark. The contribution from management action to mitigate those risks is roughly the same in the portfolio as in the benchmark.

Portfolio Carbon Emissions Exposure



Benchmark Carbon Emissions Exposure

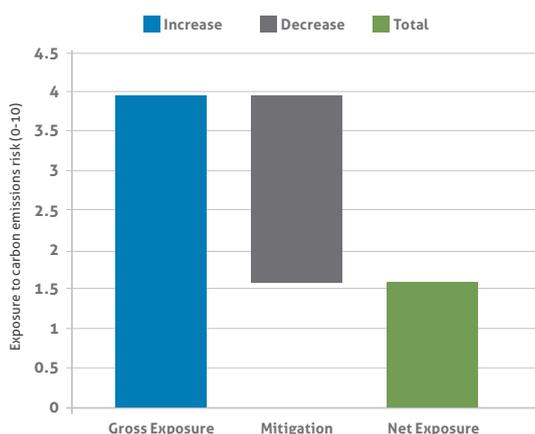


Figure 2

Source: Cameron Hume, MSCI. Gross exposure is the weighted sum of the carbon emission exposure score. Net exposure is the weighted sum of (10 – the carbon emission score). Mitigation is the weighted sum of the difference between the gross exposure and the net exposure. Portfolio is the Cameron Global Fixed Income ESG Fund. Benchmark is the Bloomberg Barclays Global Aggregate Index. All data as at end May 2020.

The revealed policy is therefore to favour issuers with lower current emissions, rather than those that are seeking to make a more rapid transition. One argument for our approach is that pursuing a more rapid transition is likely to require substantial investment. In the last decade, companies have overwhelmingly funded themselves from the bond market. Unless equity

investors contribute, this will lead to greater leverage and impaired credit quality. As a result, favouring issuers with low current emissions is one way in which to manage climate risks within a bond portfolio.

We would welcome the opportunity to discuss the fund and how we approach climate risk in investments.

⁴In credit modelling, we measure default risk in terms of losses from default, which are calculated as the product of the probability of a default and the expected loss in a default situation.

⁵Shell has committed to the Paris Agreement's 2 degree limit, and is working to achieve net zero emissions by 2050. <https://www.shell.co.uk/a-cleaner-energy-future/our-response-to-climate-change.html>

⁶This longer term reaction has been termed the 'Inevitable Policy Response' by the UNPRI: <https://www.unpri.org/inevitable-policy-response/what-is-the-inevitable-policy-response/4787.article>

⁷This is the approach embedded in the Transition Pathway Initiative and the Science Based Targets Initiative



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