Climate-Friendly Investing

By Quintin Rayer | October 10, 2019

Climate concerns have emerged as a significant theme in ethical and sustainable investing. Global warming is almost certainly the most significant challenge and the greatest threat that humanity, and our planet, face today [1]. Therefore, an increasing number of investors are focusing on reducing carbon emissions associated with their portfolios.

So concerning is global warming that MPs and UN officials have started using stronger language, replacing the familiar “climate change” with terms such as “climate emergency”, “climate crisis”, “global heating” or “climate breakdown” to better reflect the reality of the emerging catastrophe [2].

Fund managers can now use the services of companies, such as Trucost [3], Mercer [4] and Morningstar [5], to examine the carbon intensity of components of their portfolios. For example, managers can determine whether portfolios are above or below their benchmarks in terms of carbon emissions. While such relative information is helpful – there are also sources that aim to link investments more directly with climate requirements. After reviewing the background, this article introduces several of these initiatives as they are useful tools for climate-friendly investors.

Environmental and Climate

In 1983, growing realisation in national governments and multilateral institutions of linkage between economic development and environmental issues led to the establishment of the World Commission on Environment and Development by the UN General Assembly. The depletion of the Earth's atmospheric ozone layer by chlorofluorocarbons (CFCs) led to the 1989 Montreal Protocol banning these substances. In 1992, leaders set out sustainable development principles at the UN Conference on Environment and Development in Rio de Janeiro, Brazil. Three instruments of environmental governance were established: the UN Framework Convention on Climate Change (UNFCCC) [6], the Convention on Biological Diversity (CBD) and the non-legally binding Statement of Forest Principles.

Later in 1992, the UN General Assembly officially created the Commission on Sustainable Development. The 2006 Stern report [1] concluded that the benefits of decisive early action on climate change outweighed the costs. In 2007, the International Panel on Climate Change declared "it is no longer a question of whether climate change policy should be understood in the context of sustainable development goals; it is a question of how". Carbon emissions play a significant role in climate change.

Current efforts may prove to be insufficient to meet the 2015 UN FCCC intended aims of holding the increase in global average temperatures to well below 2°C above pre-industrial levels while pursuing efforts to limit increases to 1.5°C above pre-industrial levels [7]. In 2018 scientists re-iterated the need to contain global warming within 1.5°C [8].

There is growing awareness that global warming is primarily human-induced, with cumulative CO2 emissions being the leading cause of climate change. There is a realisation that action is needed if we are to meet the Paris Agreement targets to hold increases in global average temperatures to 1.5-2°C. Based on current policies, projections are for warming of 3°C to 5°C by 2100; with current global warming estimated at around 1.13°C above pre-industrial levels (September 2019) [9].

Climate-Friendly Investment Tools

Global warming is such a serious issue that several investment initiatives have been developed to help address it. These include

- The "Task Force on Climate-Related Financial Disclosures (TCFD)" [10]. The TCFD is developing voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders. The TCFD aims to help companies understand the information that financial markets will require to respond to climate risks and to align their reporting with investors' needs.

- “Science-Based Targets” [11], which aim to provide companies with a defined pathway to future-proof growth by specifying how much and how quickly they need to reduce their greenhouse gas emissions. Targets are considered “science-based” if they are in line with what the latest climate science says is necessary to meet the goals of the Paris Agreement. To limit global warming to well-below 2°C above pre-industrial levels and pursue efforts to limit warming to 1.5°C.

- The “Net Zero Carbon 10 (NZC10) target” [12]. NZC10 defines a simple systematic framework for ethical and sustainable fund managers to challenge company boards on their net-zero carbon emissions policies. NZC10 allows fund managers to better align their investment policies to the requirement for carbon-neutrality, rather than just emissions reduction. The approach focuses on net-zero emissions by 2030 – firms can have some carbon dioxide (CO_2) emissions, so long as these are reliably offset.

How this helps Advisers

Clients increasingly wish to invest ethically and often have specific concerns like global warming in mind. Younger people may give this a higher priority than older generations with twice as many 18 to 34-year-olds feeling their pensions should be invested ethically, compared with those above 45 [13]. The Investment Association reports £20.0 billion assets under management in the UK ethical funds sector in July 2019, a yearly increase of £3.2 billion [14].

The European Securities and Markets Authority (ESMA) guidelines on MiFID II say that advisers should ask about their clients’ preferences, including environmental, social and governance factors, when offering advice [15]. Advisers may have clients with a strong commitment to addressing global warming.

Advisers must be confident that the wealth managers they choose to support the ethical and sustainable investing requirements of their clients have the necessary skills and commitment. The insight P1 has into the underlying climate issues should give advisers confidence that we have the skills to support them in this significant and growing area.

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