"Is green the colour of money?"

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6 Long-term opportunities and risks in carbon management: the case of sovereign debt investing

SUMMARY: Asset owners want more sustainable investment options – increasing the need for accurate reporting of climate change exposures to assess long-term risks and opportunities. This article covers recent developments in carbon management in the financial sector, and the accompanying framework at Investec Asset Management. The case for carbon considerations in sovereign debt investing in emerging markets is explored along with the need for governments to do more for institutional investors, now that the finance industry's key role in achieving a low-carbon environment has become evident. This is particularly salient given that carbon management in sovereign fixed income remains at a formative stage.

Why climate change matters for long-term asset owners and managers

For custodians of long-term capital, strategic action around the current and future impact of climate change should be a priority. Climate change will occur over a long timescale and delays in taking action raises the risk of "those extreme scenarios where our options to deal with this threat to the global economy will be few", according to the Institute and Faculty of Actuaries[1].

The actuarial community's views reflect an increased awareness among asset-owners of the prominent role long-term capital can play in transitioning to a low-carbon economy. The risks and opportunities accompanying climate change for institutional investors can be addressed with carbon management initiatives. Such initiatives are designed to promote environmental effectiveness in organisations, particularly with regard to the consumption of resources that contribute to climate change. This can be done through accurate reporting of exposures – allowing for appropriate change management – which can be designed to capitalise on or mitigate these risks.

Asset owners, therefore, not only have a fiduciary duty to invest accordingly, but also to engage companies, regulators and their clients, if a global shift to integrating carbon management into long-term business strategies is to take place. Governments also have an important role to play in facilitating financial sector initiatives towards decarbonisation through providing a supportive policy environment and accurate economic data. This is particularly the case for carbon analysis in sovereign fixed income investing, a critical area which up until now has been neglected.

The financial sector seeks action from regulators, governments and companies on climate change

The Belgian economic think-tank, Bruegel, has urged financial institutions to measure their exposure to ecological imbalances. They have encouraged policymakers to develop and implement standards for this.

[1] Fiona Morrison, 20 October 2015. 'Transition risk is real and needs to be addressed', Financial Times: https://www.ft.com/content/dc49a75e-7658-11e5-933d-efcdc3c11c89

The push for improved carbon management has been supported by investor initiatives such as the UN Principles for Responsible Investment (UN PRI), the investor-led Global Investor Coalition on Climate change (GIC), and the Carbon Disclosure Project (CDP). The insurance industry has been working hard on carbon management issues for many years. The Economics of Climate Adaptation Working Group, championed by Swiss Re, in 2001 published a framework to quantify climate change risk to assist sovereigns.

In October 2016, Moody's Investor Service set out how it now captures the credit implications of physical climate change for sovereign issuers. In December 2016, the governor of the Bank of England, Mark Carney, and the chief executive officer and founder of Bloomberg, Michael Bloomberg, called for financial disclosure of climate change exposures to be regarded as material risks.

The challenge, though, is maintaining momentum and commitment to decarbonisation.

Some countries either made big commitments, which continue to be delayed, or have reversed policies when a new administration comes into power. Therefore, governments are critical when providing a supportive investment environment for long-term asset owners committed to the sustainability transition and decarbonisation.

The UK and France have made progress. The UK Companies Act made it compulsory in 2013 for all companies to report on their greenhouse gas emissions. France was the first country to introduce mandatory climate change-related reporting for institutional investors through Article 173 of its energy transition legislation. The French Pensions Reserve Fund accordingly made explicit commitments to gradually reduce its exposure to CO_2 emissions and fossil fuel reserves.

At the other extreme, in June 2017, the US withdrew from the COP21 Paris Agreement altogether. On the face of it, the presidential decision to withdraw from the Paris Agreement has the potential to derail global climate policy. However, comfort can be drawn from the global reaction, which has seen other signatories united in reaffirming their commitment to the agreement. There has also been commitment from within the US itself, with notable public figures, such as Michael Bloomberg, pledging to fill the funding gap for programmes already in place. There are multi-state initiatives in place in the US, such as the Midwest Greenhouse Gas Reduction Accord and Western Climate Initiative. Further, there are several other initiatives and climate action agreements that will continue to exert influence alongside the Paris Agreement with the support of local governments. Hawaii, which is under significant threat from climate change, has defied the US president and formally continued its commitment to the Paris Agreement.

Our positioning for the sustainability transition

At Investec Asset Management, we have made several commitments that we hope will enable us to harvest the opportunities of the green transition. In response to the growing momentum for improved carbon management in financial markets and increased demand for sustainable products from our clients, our senior leadership supports both internal and external efforts on climate change. The stewardship of our clients' capital is included in our sustainability framework. Our Climate Change statement[2] further outlines our commitment to act in four key areas: engagement; measurement; reallocation of capital; and advocacy.

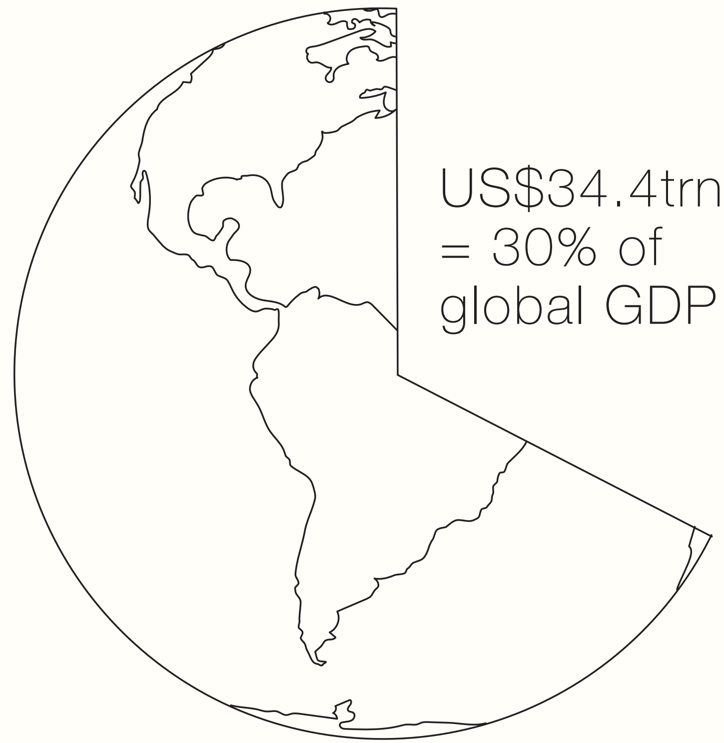
But besides mitigating transition risks, we are vigilant for opportunities.

Research by our Natural Resources investment team in 2016 found that opportunities for the financial sector industry around a changing energy future are enormous. Over US$34.3 trillion is needed to invest into new power generation projects required to meet the climate change targets set out in the Paris Climate Agreement.

Our Emerging Market Fixed Income (EMFI) team has also been exploring a potential framework of analysis for carbon exposure in sovereign fixed income, an area that to date has been neglected by investors. The possible directions in which carbon considerations for sovereigns can take place is set out by Roger Mark, from our EMFI team.

[2] Climate change statement can be found: http://www.investecassetmanagement.com/international/professional-investor/document/pdf/Investec-Stewardship-Policy.pdf

What is the price of decarbonisation?



The investment required to meet climate change targets in the Paris Agreement is equal to roughly 30% of global GDP

Carbon considerations in sovereign fixed-income investing

There are a number of reasons for the lack of a coherent framework for carbon exposures in sovereign fixed-income investing. Bondholders are not owners. It is thus a moot point as to what extent they are financing carbon emissions. Moreover, is a government bondholder financing state emissions only, or economy-wide emissions as well? It is also much easier for equity investors to engage and influence company management. As for disinvestment, it is generally a non-starter, given the need for low-risk yield, and the relatively small universe size, particularly in developed markets.

However, given the potential impact of carbon development on global economies, the time is fast approaching where investors must consider carbon trends in their sovereign investments. This is particularly important in emerging market debt, given emerging markets formative stage of development and greater susceptibility to climate change.

A sovereign perspective

Unlike some other environmental, social and governance factors, there is little evidence that environmental factors have a relationship with bonds and currency market returns. However, this will likely change as climate change risks become more apparent. From an investment perspective there are two key risks: transition risk and physical risk.

Transition risk refers to the risks inherent in moving to a low carbon world. Examples of this include stranded assets and the direct and indirect costs associated with a changing energy mix of an economy. The impact of transition costs can be felt across an economy's key metrics – growth, fiscal health, inflation and external accounts can all potentially be affected. Thus, for sovereign emerging market debt investors, it will be crucial to address this in the coming years.

A good starting point is to examine the carbon profile of a sovereign universe. As the Finance for Change initiative has argued, a carbon intensity[3] approach is likely the most relevant metric for sovereign debt

[3] Carbon intensity is defined as CO_2/US$ million GDP. It can be measured on a purely production basis, or a consumption based approach, which takes into account embedded emission from net trade.

portfolios. The level of a country's carbon intensity allows for a better understanding of its level of emissions and carbon exposure. This is useful for disclosure purposes, as well as for providing a framework for cross-asset class comparability. However, this framework should be seen as the basis for further analysis.

For example, South Africa contributes around 20% of the carbon intensity of the main emerging market local currency benchmark (more than double its weight in the index). This may not matter on a one-to-three-year investment horizon, but over the longer term, the trajectory of carbon trends in South Africa could have a material impact on its economy and asset class performance. Hence, we are is aiming to enhance our understanding of what it takes to make an economy sustainable and resilient, in the face of such transition risks, by focusing on factors such as the trend towards renewable energy, economic diversification, and exposure to stranded assets.

Physical risks are somewhat different – this is the risk of financial impact from actual climate change, which today is widely believed to be directly impacted by the increase in carbon in the atmosphere. Moody's have highlighted four key risks from physical climate change:

a) the impact of economic activity
b) damage to infrastructure
c) rising social costs
d) population shifts.

Asset returns will be driven by the magnitude and immediacy of these risks. Given the intrinsic uncertainty around both these elements, this is still some way from having an impact on assets, but this will inevitably change in the future.

Influencing behaviour

For those investors seeking to shape the transition to a lower carbon world there are also many opportunities.

For instance, it is an unfortunate irony that many of those countries most at physical risk from climate change are least responsible for the increase in greenhouse gas emissions, particularly many African countries. While there is uncertainty about the magnitude and immediacy of physical risks, governments can take steps to ensure their economies are resilient and on a sustainable trajectory to manage these risks. Similarly, transition risks can be mitigated through prudent and strategic climate policy. Environmental sustainability extends quite naturally to fiscal prudence, economic diversification, and accountable and responsive governance. As such, we believe there is a strong link to long-term investment return potential. There is scope for institutional investors to incorporate sustainability biases in their portfolio construction to reward those countries doing the right thing with lower borrowing costs at the margin, while not necessarily at the expense of lower investment returns.

The green bond market[4] is another area of opportunity. Poland, an emerging market economy, was the first to issue a sovereign green bond in a three-times-oversubscribed issue in December 2016. Elsewhere, Chinese companies have been at the forefront of corporate green bond issuance. Indeed, in our emerging market corporate strategies, we already own a number of green bonds. The sovereign green bond market is very much in a nascent stage, but has the potential to expand quickly. As the market deepens and becomes more liquid, we expect green bond issues to enter our investment universe over time. Some investors may wish to make specific allocations to green sovereign bonds and in time there may be scope for green bond portfolios, even purely at the sovereign level.

Some investors may even wish to think about incorporating dual-mandated investment return and carbon progress goals. The industry and data are not quite ready for this, but in the coming years it could be conceivable to attribute performance not just against investment goals but also against climate progress – for instance, with reference to a country's progress in achieving its Intended Nationally Determined Contributions.

Next steps: proactive financial sector engagement with policymakers

A natural next step is to influence policymakers to provide a supportive policy framework for carbon management. Some institutional investors may have the scope and willingness to do this directly. But as custodians of client money, asset managers are financial sector stakeholders that are therefore able to engage government officials directly. Indeed it is not unusual, when it comes to standard macroeconomic matters, for the interaction between policymakers and active investors to involve a mutual exchange of information and advice. The positive spill-overs from such collaborative engagements are known to be considerable, and we see no reason why this cannot be extended to discussion on carbon and climate policy.

A two-way exchange on such issues, if handled with care and with the clear intention to do the right thing, will likely also lead to having a more accurate understanding of carbon exposures. This may reduce some of the medium-term risks that active investors in those markets confront, as well as allow them to capitalise on the opportunities from the sustainable transition. Post-Paris Agreement, we believe there is a particularly fertile opportunity to secure a more sustainable future for emerging countries and their investors.

[4] Green bonds are debt instruments where proceeds are used exclusively to fund qualifying green investments.