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Why climate change measures do not make sense, and how we can fix them

Stewart Investors
Sustainable Funds Group

If asked to list climate change solutions, many of us would start with renewable energy. It is obviously a key one given the use of fossil fuels for energy is the largest contributor to greenhouse gas emissions globally[1]. However, beyond that we may soon get stuck, particularly if asked to focus on how much specific technologies or social changes can potentially contribute to decarbonising the economy; harder still if trying to identify a group of solutions which will be enough to achieve the goals of the Paris Agreement[G].

Many research providers and standard-setting bodies have been working on climate measures and disclosures for investors with mixed success. A key gap is that no current standard, when considered across a portfolio of listed-equity investments, covers the essential questions of how much of a contribution can different solutions make and whether collectively they are enough.

Some approaches focus on splitting revenues from sustainable activities like renewable energy versus unsustainable ones like burning fossil fuels, mostly based on industry involvement. More ambitious efforts like the Paris Agreement Capital Transition Assessment (PACTA), a collaboration between 2° Investing Initiative[G] and the Principles for Responsible Investment[G], goes further and looks at the capital investment plans for companies in some sectors and whether they are aligned with Paris targets.

The European Union's sustainable finance taxonomyG has undertaken the significant task of setting thresholds for different activities to draw a line between what can and cannot be called sustainable. While the TCFD (Financial Stability Board Task Force on Climate-related Financial Disclosures[G]), rather disappointingly, has suggested portfolio level carbon intensity should be the primary metric for investor disclosure and presumably management of climate risks.

Climate change is unquestionably a complex issue, more so when considered alongside the speed and scale of change required to prevent the worst impacts of this environmental crisis. It is understandable then, that attempts to measure the implications of this issue for an investment context will also carry a degree of complexity and that it would be impossible for any single metric to capture this complexity.

While the various approaches should be useful for some investor types in some contexts, as an active[G], global, sustainable development[G] focused, listed-equity investor, we have found current approaches near meaningless and often misleading. While regulators around the world expect investors to communicate to clients in plain and understandable language, our industry has built an incomprehensible jumble of information and ratings to describe climate change risks and opportunities.

For us, issues broadly fall into four areas:

Measuring the wrong things

Because of our focus on sustainable development, many of the companies in carbon-intensive sectors or with highly polluting products and services, are never going to be investible and so footprints and capital expenditure[G] plans are not helpful beyond confirming what clients would already expect. For other investors who wish to tweak around the edges of benchmarks[2] or who choose to stay invested and engage with highly polluting companies, carbon footprints and tools like PACTA will be very useful, it is just not for us.

Drawing too narrow a frame

Climate change is a systemic problem, yet too often the investment implications are looked at too narrowly.

A significant part of our investment philosophy revolves around the idea of sustainability positioning, which we often refer to as headwinds or tailwinds. The tailwinds we are looking for relate to the products or services provided by the company and so for companies offering climate solutions, the impacts are often downstream from the company itself.

The difficulty in calculating avoided emissions for these companies is part of the issue, but for us the issue runs deeper because the supply chains which support solutions are not taken into account. Take for example companies like robotics manufacturer Fanuc, liquids dispensing company Nordson and semiconductor manufacturer Taiwan Semiconductor (TSMC). All these companies provide essential technologies for the development of electric vehicles, but none would normally be classified as a solutions company.

Looking upstream reveals similar challenges. For example, the role that large buyers of wood products, such as pallet business Brambles or consumer goods company Unilever, can have on reducing deforestation and promoting forest protection is significant, but none of these important contributions would be recognised in traditional climate change assessments.

Backward looking

While PACTA considers capital expenditure plans, these are only five years out and in a few sectors. All other approaches effectively look backwards at either emissions or revenue splits. We are long-term investors and try to take at least a ten-year view, which is why sustainability considerations are so important to the way we invest. Part of looking forward is understanding how big the opportunity is likely to be years into the future, which is too often undefined in the context of investing for climate solutions.

False precision and hiding real insight through aggregation

Notwithstanding caveats in the fine print, all the approaches to measuring and describing climate change related investments, invariably offer a number at the portfolio level, often with multiple decimal places, as 'the' answer.

Our investment approach relies on qualitative and subjective analysis in the understanding of quality. While what gets measured might get managed, we believe that not everything that gets measured matters and that not everything that matters can be measured. This includes holistically understanding company relationships, competitive dynamics, stewardship and reputation to name a few. As bottom-up investors, aggregation of climate metrics hides the stories of the companies we invest in and obscures real world impacts with abstraction.

Taken together these issues have made reporting on climate change particularly challenging for us.

Fortunately there is another way. Project Drawdown was founded in 2014 by Paul Hawken and Amanda Ravenhill to uncover the most substantive solutions to stop climate change and communicate them to the world. Using rigorous analysis and review, the initiative published the bestselling book Drawdown in 2017 which catalogued 80 climate change solutions with the potential to meet the Paris Climate change goal of holding global warming to well-below 2°C. By estimating the emissions reductions possible from scaling each solution, the initiative not only catalogues practical solutions for emissions reductions, but how large each may become in the future. In 2020, Project Drawdown published a major review which updated the solutions to account for technological progress.

Using Project Drawdown's solutions we have begun an exercise to map the products, services and practices of the companies held within the strategies managed by the Sustainable Funds Group. We hope this analysis will present a balanced picture of how companies are impacting the climate and look forward to sharing the findings with you soon.

For more information on our approach please visit https://sfg.stewartinvestors.com/climate-change

[1] Source: https://www.epa.gov/ghgemissions/global-greenhouse-gas-emissions-data

[2] Some other investors start with the benchmark and they make changes to that. Many low carbon strategies, particularly Exchange Traded Funds make tweaks to the benchmark to reduce carbon exposure.

Glossary

Bottom-up: analysis of a company focused principally on its management, franchise and financials rather than the broader industry in which it operates, or macroeconomic factors, such as economic growth.

Headwinds: conditions which slow growth or progress.

Tailwinds: conditions favourable to growth or progress.

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Contact details

Edinburgh

23 St Andrew Square
Edinburgh EH2 1BB
United Kingdom
t. +44 (0) 131 473 2900

London

Finsbury Circus House
15 Finsbury Circus
London EC2M 7EB
United Kingdom
t. +44 (0) 207 332 6500

Singapore

58 Duxton Road
2nd & 3rd Floor
Singapore 089522
t. +65 680 59670

Sydney

Suite 10, Level 3
13 Hickson Road
Dawes Point
Sydney NSW
Australia 2000
t. +61 2 8274 8000

info@stewartinvestors.com
stewartinvestors.com