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Reframing the climate question

How should an investor balance a focus on reducing their climate impact with a desire for financial returns? And how does a company management team accommodate what can often be seen as competing demands?

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This negative framing of the climate question is evident in many investors. Yet it's often even more apparent in companies, for whom addressing carbon emissions can be a clear priority in times of plenty, but as soon as either company specific or broader economic headwinds emerge, the issue can quickly become a 'tug of war' between sustainability and finance teams – with a CEO and board stuck in the middle.

However, it is our firm belief that instead of framing the challenges and opportunities of the energy transition in these terms, investors and companies could be asking a different, more positive question: how can these opportunities and risks be addressed simultaneously?

In fact, we believe that addressing the opportunities and risks created by the energy transition to help target a positive impact on climate outcomes can be closely aligned with a focus on long-term returns. However, far from maximising the potential value created by the transition, many companies are still failing to transition at an optimal pace.

It's the combination of the false framing of the climate question and the slow transition progress of many companies that, in our view, create such a significant opportunity for active investors to have both a positive impact on climate outcomes and also target returns. On the one hand, many still misunderstand the fundamentally economic nature of decarbonisation – leading to the possibility of material mispricing for investors to take advantage of; on the other hand there is a window of opportunity for investors to engage with and positively influence those companies who continue to underperform their real climate potential.

Excitingly, we also believe that a focus on seeking the greatest positive societal impact through lower emissions can be extremely well-aligned with targeting increased shareholder value. That's because those companies with the highest carbon emissions, or whose products can have the greatest impact on others' emissions – exactly the sorts of companies upon whom we will focus our efforts – in our view are also likely to be the type of companies for whom successful engagement can have the greatest potential impact on real-world emissions.

Harnessing this opportunity requires close partnership between asset owners and asset managers, as well as between active ownership and active investors, as we believe value creation is likely to come from a combination of effective engagement and stock selection. It's not enough just to buy the stocks with the greatest potential for positive change. Pro-active and profound engagement with those companies is crucial to help ensure that that potential is realised.

To achieve this, LGIM and AP7 have collaborated closely to design and develop an innovative approach from scratch that aims to accelerate the transition to a net-zero world, while also seeking to unlock shareholder value.

LGIM's partnership with AP7 underpins our conviction behind this approach – a hypothesis which challenges much of the conventional wisdom around climate investing. The traditional ESG approach of investing in companies that are already aligning with the Paris goals, or simply in those who by the nature of their business model inherently have a very low carbon footprint, does not necessarily – in isolation – provide the best opportunities for investors.

In fact, we believe that an investor can potentially target the greatest climate impact – and also potentially the greatest returns – by investing in those companies that have high emissions, and then engaging effectively to drive them down over time, as well as by driving greater capital allocation to the opportunities that the transition could create for their business.

Read our latest report Climate change: Inaction is not an option for more details.

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