Carbon Footprints: Where do they lead?

mirova
Responsible Investing

Hervé Guez,
Global Head of Research and CIO of Equities & Fixed Income at Mirova

The world is changing. Investors can no longer look to existing strategies and indexes – clearly representative of the "old" economy – to be sufficient during the current transition towards the "new". This is especially true regarding environmental issues in light of the Paris Agreement, the recent UN Sustainable Development Goals becoming standard for investment strategy assessments, and increasing public and regulatory pressure.

Over the past year for instance, the French Article 173 has required investors to report on the non-financial impacts of their investments. The notion of fiduciary duty is being questioned because it does not (yet) include environmental, social, and governance risks. The public, made up of none other than final investors, is becoming increasingly exigent in its calls for action to combat climate change. No matter whether rooted in a moral calling to protect the environment or a desire to avoid the risks associated with this economic transition, it is time for institutional investors to look at the ESG impacts of their investments.

The trajectory is clear. But, before setting a goal-post, it is important to assess the starting point; a robust and reliable carbon footprinting methodology serves as the basic tool for assessing and improving climate impact.

THE ART OF INTERPRETING CARBON FOOTPRINTS

There are several methods for measuring carbon footprints of investments, but they generally do not consider a company's entire business model. Some rely only on a company's direct emissions and the emissions from its energy use. Others do not consider the benefits of products through measures like avoided emissions. Both are essential for understanding a company's, and consequently a portfolio's, climate impacts.

First, looking only at direct and energy use emissions does not take into account supply chain or use-phase emissions. Most of oil and gas extraction companies' carbon footprint comes from the use of their products by the final consumer; this is not captured unless use-phase emissions are estimated. Though simple, this example illustrates by itself that an issuer's direct emissions alone can inadequately depict its climate impacts, potentially misrepresenting the company's risk exposure.

Then, consider a company that manufactures cosmetics and a company that manufactures wind turbines. Looking at direct and energy-use emissions alone, their carbon footprints are the same. But this is counterintuitive: doesn't a turbine manufacturer contribute far more to the energy transition? For this reason, it is essential to also consider the emissions avoided by the companies' activities relative to the regional energy mix. The turbine company's avoided emissions will be far higher than the cosmetics company's, demonstrating the far greater magnitude of its positive climate impacts.

As an investment manager, we believe that measuring the carbon footprints of our investments is a crucial issue. Unsatisfied with existing methods, we decided to team up with experts to develop an innovative methodology able to calculate both lifecycle and avoided emissions. This data is translated into a telling climate scenario indicator, which helps us to understand the relative impacts of our strategies and provides a roadmap for reorienting investments.

FOLLOWING INDEXES: ARE WE ON THE WRONG TRACK?

We believe that recognising the need to invest in a way compatible with the international consensus of limiting global warming to 2°C is the first step forward for investors. Understanding the various approaches to carbon accounting, looking at both climate opportunities and risks, the second. Then comes the most important step: acting on it.

Indexes still have a long way to go as far as climate issues are concerned. Most represent an economy on track to achieve a 4.5°C-5.5°C climate scenario, indicating severe, adverse effects. Sectors most exposed to climate change (energy, resources, buildings, and mobility) make up a substantial part of the major indexes, and large companies in these sectors have yet to sufficiently develop innovative solutions to compensate for their presence in and contributions to the fossil-fuel reliant economy. This reflects the richness of large industrial groups in the world economy, as well as the lack of risk capital for new companies. And, as a result, passively-managed funds that track traditional indices are in line with the "old" economy rather than seeking to balance it with the "new", low-carbon economy.

Therefore, strategies relying on the major market indexes are not sufficient to mitigate the diverse risks associated with climate change. Passive management, which is nothing more than the choice to not choose, will not do it this time. But, there remain several potential paths for making investments more climate-friendly, namely carbon-conscious active management strategies that are not closely linked to indexes.

NEXT STEPS FOR INVESTORS

Active managers can allocate the capital at their disposal in ways that address the environmental, social, governance, regulatory, and reputational risks ahead. If these strategies are well designed, they fuel themselves: seizing new investment opportunities generates better medium-term profits while mitigating climate change, which will in turn ensure better profits over the long-term. Not only does this carbon-conscious active management approach reduce long-term risk, but it encourages innovation, which can lead to even more opportunities related to the transitioning economy.

So, investors looking to reduce the climate impacts of their investments and perform over the long-term can seek out asset managers which have thoroughly assessed and begun to tackle the task at hand. Until carbon footprinting methodologies for creating low-carbon indexes are developed and applied, offerings mainly consist of actively-managed strategies that take carbon impacts into account, though methodological differences could lead to differing levels of impact. At Mirova, we have worked to decrease our strategies' carbon impact, to line up with the 2°C objective, without hindering their performance . Today, our consolidated equity funds are compatible with a 1.5°C scenario, compared to 2.9°C two years ago. This was achieved by looking for investment opportunities beyond the obvious: not just renewable equipment manufacturers but throughout the entire value chain of renewable energy and energy efficiency solutions. And not just large companies present in indexes, but also mid-cap companies with sound business models proposing innovative solutions. Through this active, carbon-conscious management of both diversified and thematic strategies, Mirova has substantially reduced the climate profile of its investments – and thus its exposure to the associated risks – all with a view to generate sustainable, long-term performance.

The world is changing and so are we. Finance can and must play a role in transitioning to the "new" economy and staving off the worst effects of climate change by providing investment solutions designed to address the associated opportunities and risks. Step by step, investors' carbon footprints can become lighter.

NATIXIS
INVESTMENT MANAGERS

Mirova is an affiliate of Natixis Investment Managers.

FOR PROFESSIONAL CLIENTS ONLY. In the UK: Provided by Natixis Investment Managers UK Limited (One Carter Lane, London, EC4V 5ER), which is authorised and regulated by the UK Financial Conduct Authority (register No. 190258). In the E.U. (outside of the UK): Provided by Natixis Investment Managers S.A. or one of its branch offices. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. In Switzerland: Provided by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.

MIROVA French Public Limited liability company with board of Directors. Regulated by AMF under n°GP 02-014 RCS Paris n°394 648 216. Registered Office: 59, Avenue Pierre Mendes France – 75013 - Paris. Mirova is a subsidiary of Ostrum Asset Management.