Creating a climate for sustainability

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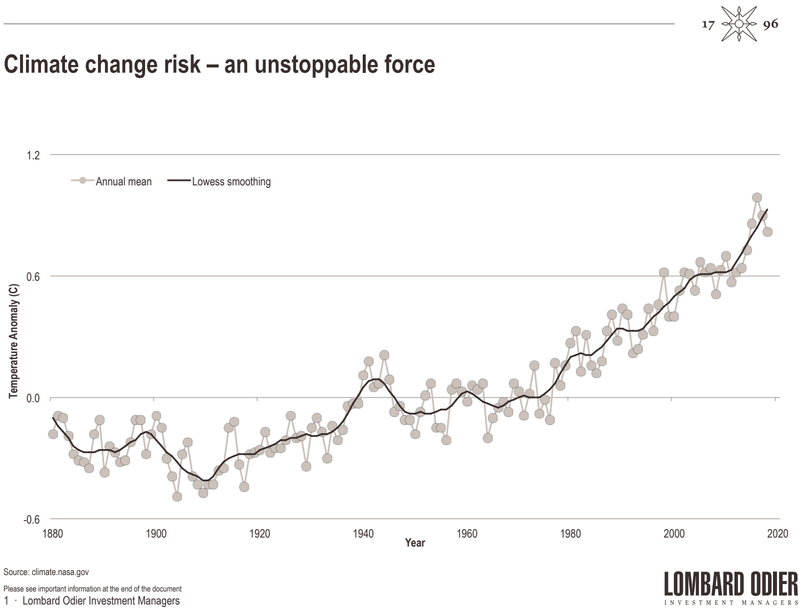
Climate change is one of the most pressing sustainability challenges investors are facing today. It presents a systemic risk that is very difficult for investors to diversify away.

The physical risks associated with a rise in global temperatures, and the transition risks created by shifting towards a low-carbon economy are already having wide-reaching consequences for society, for the global economy, and for investment portfolios.

In response, we believe it is now mission-critical for the investment process to adapt and innovate to mitigate climate risk, and to take advantage of the many opportunities a transition to a low-carbon economy will create.



Climate change risk – an unstoppable force

The 2015 Paris Agreement, which brought global governments together for the first time in history in a landmark agreement to limit global warming to 'well below' 2 Degrees Centigrade this century, has set our economies on an irrevocable transition towards a low-carbon, more sustainable operating model. We believe there will be nowhere to hide from this transition as it will affect every investment portfolio over the course of time.

The evolution towards a low-carbon economy will create transition risk from changes in policy and regulation, technology, market risks and can also create reputational risks for companies. These factors affect investors as companies have to grapple with rising costs in the supply chain, innovation and the development of new technologies, and falling demand for products that are not considered to be climate friendly.

On the other hand, the physical environment is also changing, characterized by increasing severity and frequency of extreme events like hurricanes, droughts, floods, forest fires etc., as well as more long-term changes to our environment like rising sea-levels, changing ocean currents and prolonged heat waves. These changes have been shown to destroy significant value for investors. A report by Munich Re showed extreme weather events caused record economic losses of $160bn in 2018, for example.

Adapting the investment process for the climate change era

We believe it is now critical for the investment process to embed consideration of climate change in order to mitigate the risks, and take advantage of the opportunities a transition on this scale will inevitably create.

At Lombard Odier Investment Managers, we can do this in two ways.

First, we can favour companies with more sustainable environmental business practices and lower carbon intensity versus their peers. This works to reduce the exposure of the portfolio to climate change risk and we can do this across all our mainstream asset classes, whether that is equities, fixed income or convertibles.

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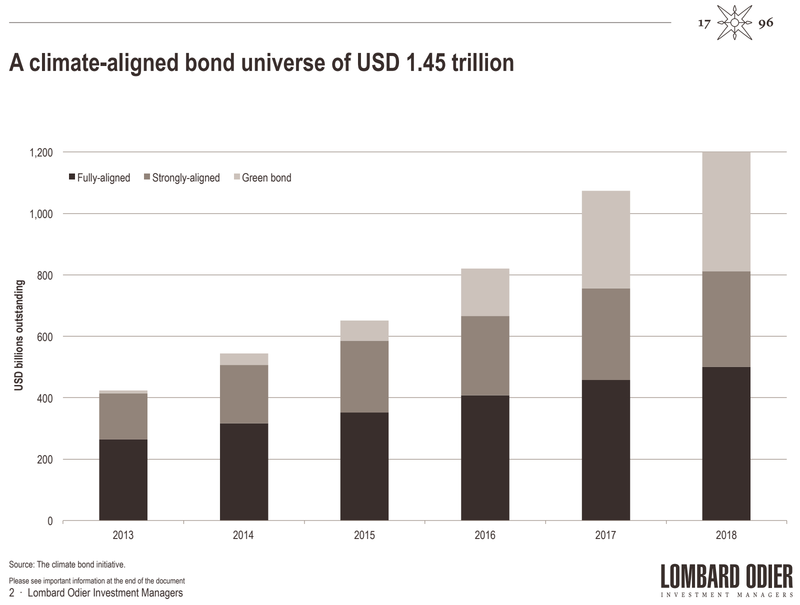
This requires the collection, filtering, verifying and enhancing large amounts of raw data at the most granular extra-financial level possible. We do this through conventional and alternative routes, actively collaborating with data providers and research sources. This gives us a deep and diversified dataset, that also captures a forward-looking view of the physical and transition risks climate change presents at the company and asset level.

We then analyse this data from several different viewpoints. This includes our proprietary CAR approach (Consciousness, Action, Results), which helps us differentiate between companies that are achieving genuine results on the path to better environmental business practices, and those who are just talking about it. We also analyse the alignment of companies' environmental business practices to the Sustainable Development Goals (SDGs). This approach gives us a better understanding of genuine sustainability that is more informative to the investment process than simply buying an external rating, and allows us to align portfolios to the SDGs, notably Goal 13 in the case of climate.

This is why we place such a strong emphasis on the quality



and diversity of our raw data. We believe our information has to be as robust as possible and be forward-looking to be fully investment-relevant.

Second, in addition to tilting on climate-related business practices and carbon intensity, in fixed income we can invest in climate-aligned bonds to help avoid carbon emissions in the portfolio.

This is a rapidly growing asset class. The Climate Bond Initiative estimates the market for climate-aligned bonds has nearly tripled over the last five years to USD 1.4 trillion in outstanding bonds.

This gives us a much more diverse and liquid opportunity set, and because the use of the assets is clearly ring-fenced for climate-friendly projects, the outcome of the investment can be more easily measured in terms of carbon emissions avoided. Climate bonds represent a small, but growing segment of the fixed income market. We believe they will continue to grow in prominence as the transition to a low-carbon economy unfolds and the OECD is projecting the market could grow to in excess of $5 trillion by 2035.

We believe companies who manage their carbon intensity relatively well, or who issue climate-aligned bonds, are more likely to be better positioned in this changing environment. As the world transitions to a low-carbon economy, companies that are proactive in managing

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their exposure to climate risk will be more resilient as they are better positioned to adapt to new regulations, innovation, or a shift in consumer appetite.

By mitigating these risks in the portfolios, we can also help in the fight against climate change by creating a positive impact on the environment and society.

For us, identifying companies that are well positioned for the transition to a low-carbon economy is a key aspect of delivering sustainable investment returns in the future. Climate change, as a systemic risk, is something investors can no longer afford to ignore.

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