

## CIO Viewpoint

## Climate, investors and the IPCC's 'code red'

Investment Solutions

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A United Nations' report this month concluded that with carbon dioxide in the atmosphere at a two million-year high, the evidence for human activity on climate change is "unequivocal". The first part of UN's Intergovernmental Panel on Climate Change report, the sixth since 2013, underlines our conviction that companies have to act faster, creating market winners and opportunities to invest in the transition to a net-zero carbon economy that offer better risk-adjusted returns.

The report lays out the stark impact of climate change, coupling data with evidence of flooding, drought and wildfires. UN Secretary General António Guterres [described](#) the situation as a "code red for humanity". This century, the 2 degree Celsius tipping-point for irreversible climate change will be breached unless we manage deep reductions in carbon dioxide (CO<sub>2</sub>) and other greenhouse gas emissions in the coming decades.

The IPCC report should strengthen already firm demand for investment solutions that tackle climate change. It signals a period of intensified market sensitivity and reaction to climate-related risks, altering the investment universe. In 2020, the market capitalisation of "clean tech" companies grew by about USD 1 trillion, while that of oil and gas companies shrank by about USD 680 billion, according to the [World Economic Forum](#).

### Three key risks

Investors would do well to factor in three climate-related risks – transition, physical and liability – when making their investment decisions:

First, exposure to the transition to a net-zero emissions economy, poses a number of risks from regulation, to carbon taxes, and demand-side shifts as customers move away from carbon-heavy products and services. For firms unwilling or unable to adjust, this represents an existential risk, while there is scope for companies to generate value through climate-positive business strategies.

Second, assets exposed to global warming's physical risks, in other words more frequent extreme events such as hurricanes, flooding, and wildfires, face important valuation questions. Companies whose assets, supply chains, or customer bases are located in high-risk regions could experience significant financial losses. Clearly, this is an issue for sectors such as real estate and the insurance sector.



Stéphane Monier  
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### Key takeaways

- Market sensitivity to climate-risks is intensifying, altering the investment universe
- Investors should factor transition, physical and liability risks into their portfolio decisions
- Climate Value Impact (CVI) assesses companies' overall exposure to related risks
- We are convinced that investors who contribute to the net-zero transition will benefit from higher risk-adjusted returns.

**Important information:** Please read the important information at the end of the document.

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Finally, both the private and public sectors are exposed to liability risks as a company's responsibility for reducing greenhouse gas emissions and their impact on climate change become clearer, potentially creating substantial liabilities on some balance sheets. We are seeing climate-related litigation, holding to account companies for their historical emissions, their failure to mitigate these emissions, or the failure to adapt their infrastructure. The Grantham Research Institute on Climate Change and the Environment at the London School of Economics counts 1,859 climate-litigation cases in their database.

In May this year, Royal Dutch Shell was [ordered](#) by a court in the Hague to cut carbon emissions by 45% compared with 2019 levels, by the end of 2030. The Dutch court found the company's emission-cutting plans too vague and ordered it to fall in line with Paris agreement commitments. In March, the US Securities and Exchange Commission [announced](#) that it is looking at harmonising company disclosures on climate-related risks, making it comparable, and potentially open to challenge.

As investors, we aim to assess these climate-related risks and their likely impact on the value of a portfolio's assets using a metric that we call Climate Value Impact (CVI). This measures a firm's total exposure to this three-pronged climate risk, and helps to analyse how that affects their valuation.

Of the three risks, we believe transition risks are currently the most significant. Transition exposure, under certain global warming scenarios, aims to identify the proportion of any company's revenues that could be hit by the transition to a net-zero economy.

CVI allows us to separate companies between those that are insulated from transition exposure (because their revenues are unrelated to greenhouse gas emissions); those that may have a significant carbon footprint but are nonetheless helping to reduce emissions elsewhere in the economy; those that are highly exposed to transition exposure because of high emissions yet are on the right trajectory with what we call 'ice cube'-type revenues; and those that are similarly exposed but are on the wrong trajectory, with 'burning log'-type revenues.

This analysis helps us to determine how much of a company's revenues would be exposed to the transition to a net-zero economy and whether these revenues would be positively or negatively exposed.

In this way, we aim to distinguish between companies in order to make better, climate-informed investment allocations. Companies positively-exposed to the climate transition, because they offer products and services that stand to benefit from increased demand as the transition progresses, such as renewables and e-mobility, will be positively exposed to CVI.

Companies in high-emitting industries – including steel, cement and chemicals – will be highly exposed to CVI, but whether this exposure is positive or adverse will largely depend on their transition strategies. Transitioning leaders may access significant market gains.

### **The imperative of action**

If extreme events become more frequent, then net zero by 2050 may no longer be enough. If that target is not advanced, then more adaptation initiatives will be needed to minimise the adverse effects of climate change. These considerations should push the need to balance investment decisions that address mitigation with those that address adaptation. All this means that action now is even more urgent.

Central banks are increasingly playing a part on the policy front. The European Central Bank recently published an [action plan](#) setting out its intended progress on the transition to a carbon neutral economy. It includes developing new experimental indicators, covering relevant green financial instruments and the carbon footprint of financial institutions, as well as their exposures to climate-related physical risks, and a plan to start conducting climate stress tests of the Eurosystem balance sheet in 2022.

As we head towards the [UN's November meeting](#) in Glasgow, it is clear that investors have a major role to play in contributing to positive climate outcomes. Fortunately the expertise exists to help make that happen. There is no time to lose.

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