

## **Portfolio decarbonisation: making sure tomorrow never dies**

**The need to de-carbonise portfolios seems to have been broadly accepted, and many initiatives have been launched by investors on this topic: the Portfolio Decarbonisation Coalition, the Montreal Pledge, and events such as the Climate Finance Day, to name only a few. However, in order to address portfolio decarbonisation efficiently, we need to answer the very question that lies behind this good will: why would financial industry players ever want to do such a thing? What is their real motivation?**

### **Motivations matter**

As part of a partnership concluded in 2012 with the Cambridge Institute for Sustainability Leadership (CISL), Mirova has brought together a group of investors known as the "Investment Leaders Group" (ILG). Their aim is to develop and promote concrete tools and measures that, once implemented, can increase the efficacy of responsible investment. Last year, the ILG released a report entitled *The Value of Responsible Investing*, which examined investors' motivations to invest responsibly. The report looked at three aspects of the argument in favour of Responsible Investment: the economic case, the financial case and the moral case. All three contribute to a global motivation capable of inducing concrete action.

In addressing climate change, we need to think along the same lines. As players in the financial industry, we cannot separate these three elements, we must think of them as an integrated issue. From an economic point of view, climate change will have major consequences that we cannot ignore. From a strictly financial perspective, a potential regulation of carbon threatens the value of our portfolios. From a moral point of view, we have a responsibility, as economic actors and stakeholders in society, to do our best to meet the challenge of climate change.

When examining financial players' motivations, what we find first is that recognition of regulatory risk seems to be on the rise, encouraging players to develop solutions for dealing with it. This leads to strategies aimed at reducing portfolios' carbon risk, for example by reducing the weighting of certain carbon-intensive companies or sectors, while overweighting other, less carbon intensive, sectors.

We believe that this is not enough. Such half-hearted decarbonisation, even if it applies to a significant portion of financial assets, meets neither the economic challenges ahead nor, especially, the challenge of responsibility that is ours.

There are two reasons for this.

### **Carbon footprint: a complex matter**

Measuring the carbon footprint of a portfolio is a complex issue. The Carbon measurement methods currently employed generally rely on tools focusing on direct impacts. This means that the impact of an oil company, for instance, will be reduced to carbon issued during oil extraction. It also means that the carbon impact of a wind turbine manufacturer will simply ignore the fact that the company's product reduces GHG emissions for several decades. Such methodologies ultimately lead to a situation where the highest carbon risk lies with companies such as cement makers, for example, while the least "carbon intensive" sectors will be Media ... and banks!

A straightforward application of these methods leads to increased weighting of the banking sector at the expense of cement-making companies in portfolios. Can we really say that such an action adequately addresses the energy transition challenge? We don't think so.

Other investors apply a "best in class" methodology, selecting the least emissive companies in each sector rather than focusing on less emissive sectors, and thereby remaining sector-neutral. This strategy is also open to attack: sector neutrality is by essence a form of non-engagement. Applying it will not support investments in innovation or the energy transition.

Reducing the direct carbon footprint of a portfolio by erasing highly emissive companies is not enough, and can even be counterproductive. Indeed, sectors responsible for releasing significant carbon are where real leverage is possible, and cannot simply be overlooked. Rather than relying on incomplete methodologies and investing in low emissive companies, we believe that a strong shift in asset allocation is needed to combat climate change. A shift that would be favourable to renewable energy and projects promoting energy efficiency. A shift that would direct savings to companies and projects that enable the energy transition, as well as companies which manufacture products or develop services with a measurable positive impact on greenhouse gas emissions. To identify these companies, it is essential to understand their real impacts. This means keeping track, not merely of the carbon released by their activities, but also the carbon induced by their products and services, in a word, the carbon footprint of their business models.

In order to accelerate a shift to this approach, Mirova and the consulting firm Carbone 4 are currently developing a carbon impact methodology that combines direct and indirect GHG emissions, to assess the percentage of investments favourable to the transition. What does this mean? Imagine you want to compare a large producer of hydropower with an integrated oil company. The former's direct carbon emissions are very high, half those of the latter despite its much smaller size. However, our methodology also indicates that the producer of electricity successfully avoids 1.4 times more emissions than it releases. The oil company, on the other hand, shows 0 emissions avoided, illustrating that the business model of one firm contributes to the energy transition, whereas the other's does not. We believe that a ratio (emissions avoided/emissions released) is a far better indicator than direct emissions alone.

### **Passive management, active failure**

The second barrier to decarbonisation is the current weight of passive management. We hear it said that it would be possible to reduce the carbon impact while minimizing tracking error relative to market indices. This combination of passive management and decarbonisation is considered a perfectly adequate first step for big institutional investors. We find this somewhat disturbing.

Indeed, at the same time, so-called « smart beta » or smart indices (minimum variance, for example) are very successful. These smart indices deviate significantly from traditional market indices. The tracking error of a minimum variance strategy is about 6%. This shows that investors are ready to tolerate deviation, when it serves a purpose: here, reducing financial risk. Why is it assumed that they would not accept the same thing for low-carbon products?

We believe that investors do have the capacity to support deviations from market indices.

Meeting the climate-change challenge entails a reallocation of investments. Saying that the energy transition requires massive investment does not mean massive new investments. It mostly means divesting from companies or sectors whose business models are not sustainable, to invest in companies or sectors offering real solutions. A report issued by The Green Growth Action Alliance, a partnership between the public and private sectors to scale-up private investment in "green" sectors, claims that 90% of the investments needed are actually reallocations of existing investments. Most of the money is already out there; the challenge now is getting investors to redirect it. In this regard, the financial industry has a central role to play. Players have to accept that no real solution can be based on "business as usual," even a nipped, tucked and adjusted business as usual, and recognize that a substantial change in asset allocation is necessary.

The infrastructure sector is a striking example: according to the OECD, it occupies only 1% of institutional investors' portfolios, and only 3% of this 1% is invested in renewable energy projects. Measures need to be taken to encourage investments in these kinds of projects.

### **Public help wanted**

The efforts of governments to support responsible investment and long-term decarbonisation are crucial. At the level of each State, as well as at an international level, the industry would benefit from measures to make investments favourable to energy transition more attractive than others, and from actions to improve standardization and harmonisation.

Some progress has already been made, such as the creation of EU Long Term Investment Funds (LTIF). These new financing vehicles aimed at institutional investors should increase the pool of capital available for companies and infrastructure projects over the long term. Nevertheless, insurance companies remain too constrained by solvency rules. To make investment in renewable energy projects more attractive, these rules need to be updated.

On the other hand, we find the EU's on-going consultation on Capital Markets Union (CMU) quite depressing. The process treats finance and capital markets as if they were a goal in themselves, independent from the rest of the economy. The consultation's objective was to improve how capital markets function, but it never raises the issue of what they should serve first. We believe that the efficiency of capital markets cannot be an objective in and of itself; it matters only because of what it makes possible, which should include the financing of sustainable companies and projects. Looking elsewhere, however, Aviva has proposed a Sustainable CMU (SCMU), and we fully endorse this idea.

Last, but not least, it is essential for securing and facilitating investment that "positive" financial products be easily identified by investors. Some products already have meaningful names that can guide potential consumers: Green Bonds, or Green Funds for example. But even these titles are still self-attributed. Sustainable investment would significantly benefit from government help in implementing standards, creating restrictive labels and making dedicated indexes credible.

Real solutions for decarbonising portfolios and meeting the climate change challenge already exist. Green Bonds, Renewable Energy Funds, Green Equity Funds: the financial industry is designing and offering more and more options to investors ready to make real choices. By real choice, we mean more than marginal alterations to current portfolios intended to limit risks. We mean educated and engaged choices, based on reliable carbon measurement methodologies; choices that will contribute to a significant asset allocation shift and participate in financing the energy transition. The actions of governments and regulators, once they are translated into concrete measures, should help investors make these choices. As responsible investors, deeply involved in market organisation, we hope and believe that the current climate of general awareness and the multiple initiatives now emerging will allow the industry to achieve significant progress. This is what we work at every day.

### **About Mirova**

*Mirova offers a global responsible investing approach involving Equities, Fixed Income, Infrastructure, Impact Investing, and Voting and Engagement. It has €4.5 billion in assets under management and €38.3 billion in Voting and Engagement. It has a team of some 40 multidisciplinary experts (specialists in thematic investment management, engineers, financial and environmental, social and governance analysts, project financing specialists and experts in solidarity finance).*

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