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Transition Opportunities for a 21st Century Portfolio

Introduction

Economic forecasts are the cornerstone for budgetary decisions of many corporate executives. For asset owners, asset managers, and many in the financial industry, return expectations have long been used as the basis for strategic asset allocation adjustments. For many asset owners, this now also includes accounting for impacts of climate change and the proliferating trends in sustainability investments.

Climate change initiatives have many over-lapping attributes within the orbit of ESG and sustainability. It is reasonable to expect the powerful momentum behind these distinct but related disciplines will continue to exert ever-growing influence on asset pricing. Thus, we believe transition to a more climate-aware and sustainable world has the potential to present numerous investment opportunities. We believe that alpha can be generated by investing in issuers that are transitioning faster than their peers to a “greener” future.

MetLife Investment Management

What is a "Climate Aware" Portfolio?

For MIM, it means investing in issuers that are "changing forward faster". In other words, we seek issuers that are trying to transition fastest and most efficiently to combat extreme weather and to stay ahead-of-the-curve as policies, technologies, sentiment, and the global regulatory environment all continue to shift.

Investing in companies that are transparent about making measurable reductions to their carbon emissions is one example. Alternatively, investments could involve companies of high-carbon emitting industries, such as, cement, steel, or oil production, but who are transitioning into new methods or technologies. More generally, the focus shifts to companies that are incorporating the risks and opportunities posed by climate change into their strategy and operations.

The popular notion that these actions come at a net cost to investment performance or with economic corrosion is, we believe, simply not accurate. By seeking to avoid climate-related damages through security selection focused on GHG emission transparency and reductions, we strongly believe we can ultimately achieve better returns over time.

A Brief History

For the most part, too many conversations have approached the topic of climate change with indifference or skepticism. There has been little alignment or agreement between scientists and environmentalists on the one side and the politicians and industrialists on the other. In recent years - particularly after the Paris Agreement's adoption 2015 - powerful trends have emerged setting "best practice" standards for how trillions of dollars should be invested in a "responsible" manner. These initiatives are increasingly impacting how capital gets allocated and, in turn, how companies are getting valued in the marketplace.

> It is important for asset managers to take notice.

Even those skeptical about climate change must be noticing the unusual and highly damaging extreme weather events that have taken place in recent years. One of the most visible consequences of the warming world are the increases in the intensity, frequency, and prolonged periods of extreme weather events. Cities, states, and businesses have been taking added steps to prepare for more occurrences of acute physical risk such as extreme participation, floods, and hurricanes. Examples of chronic physical risk include rising sea levels, drought, and rising temperatures; extreme heatwaves in Asia, Europe, and North America have commanded attention over the summer months in the northern hemisphere. Perhaps more insidiously, there are also many second order effects, such as the impacts on prices and availability for food, water, and critical infrastructure, to name a few.

Regulation as a Driver

Many asset owners are now including climate risks as part of their investment process. The global economy has taken dramatic steps since the Paris Agreement in 2015, with accelerating speed in the wake of the global COVID-19 pandemic. In 2019, only 10% of global emissions were covered by national pledges (29 countries) to achieve net zero emissions[1]. Through the first nine months of 2022, 136 countries have set net zero pledges: these countries account for 83% of global GHG emissions, 91% of global GDP on a purchasing power parity basis, and 80% of the world's population[2]. Understanding how countries' decarbonization commitments interact with issuers' capital allocation plans and balance sheet strength will be a necessity moving forward.

Similarly, emphasis on climate-related disclosures continues to quicken. While the United States is making strides, Europe continues to lead the way in many of these areas. The European Insurance and Occupational Pensions Authority (EIOPA) recently formulated a series of climate change risk scenarios. Similarly, the European Central Bank and the Bank of England have begun conducting climate risk stress tests. The EIOPA believes that "it is important to encourage a forward—looking management of these risks" given that they "will be impacted by climate change-related physical and transition risk". Moreover, thousands of firms voluntarily produce climate-related data under the Task Force on Climate-Related Financial Disclosure's framework. To date, nine countries have announced plans to mandate climate risk disclosures modelled after the TCFD. Understanding these laws and risks when buying a financial asset today is important and will remain so going forward as countries continue to reassess and strengthen their decarbonization commitments.

Positive and Negative Screening

We firmly believe properly constructing a climate-aware portfolio by capturing aspects such as active transition to corporate decarbonization can be a meaningful driver of long-term alpha. However, it is a complicated process involving many variables and not just a simple measurement of which company is reducing GHG emissions. More importantly, we feel it cannot be achieved through negative or exclusionary screens alone, but rather requires extensive verification and impact analysis coupled with traditional credit research.

Many climate-related events portend long-haul secular challenges to come, and those that try to confront them proactively are likely to be best positioned for value creation over the long-term. The ability to capture such data on a wide scale is still in its infancy, and investor interest has outrun the industry's current provisions. Therefore, engagement with the issuer forms a key part of the investment process, allowing managers to identify firms that have processes for managing climate-related risks, have set long-term quantitative targets for GHG reductions, and undertake climate scenario planning, along with other factors.

Negative screening is becoming increasingly common, particularly among asset owners, rating agencies and consultants. It can rely on exclusionary criteria to help filter out unsavory behavior and companies with excessively high GHG emissions. However, negative screening criteria are a snapshot in time and backward looking. The rigid metrics removes any judgement-based context, yielding only a binary outcome.

Positive selection is forward looking and allows judgement to be made based on the direction an organization is traveling. In other words, positive selection is about finding those who are "changing forward faster" which we believe will lead to a business that is worth more than their current spreads may imply and ultimately lead to improved performance over time.[3]

Physical Risk versus Transition Risk

Whether its high winds, droughts, or wildfires, climate is physically impacting assets. What will happen and what is expected to happen in the future is therefore having an ever-greater impact on asset values today. And crucially, many of the companies that operate in these "hard-to-abate" sectors mentioned earlier have large amount of fixed assets. Those that shield themselves from acute and chronic physical risk factors and anticipate forthcoming regulations, legislations, and new technologies, we believe will be best positioned.

This all may sound easy but doing the proper diligence can be abstract or elusive. The right questions are hard to find, and the data can be questionable and volatile. Conducting an impact analysis is important but thought needs to be placed on how the data is being measured and whether it can even be trusted.

> The availability, reliability, and comparability of the data is not just a challenge to investment managers and assets owners but is a challenge for issuers and regulators as well.

In this light, we believe it is important to place a heavy degree of emphasis on engagement with the corporate borrower to learn what those companies are doing, what the management teams are thinking, and what their goals and objectives are regarding their carbon footprint. As mentioned earlier, it is vital to learn if they are putting capital and organizational systems behind these goals and objectives thereby showing real commitment, or just paying lip service to the value of decarbonization.

Further Challenges

The global energy complex is in the midst of a major transition to clean energy. An ever-growing number of countries and companies are taking action to reduce their greenhouse gas emissions to net zero. The energy transition toward clean, affordable, and reliable renewable energy sources has huge challenges.

Many renewables have tradeoffs and compete for land, have extraction, or set up costs, and have lower energy intensity. Many also rely on critical minerals such as copper, lithium, nickel, cobalt, and rare earth elements. These minerals are also geographically concentrated and thus subjected to geo-political risk. Existing regulatory, legislative, and permitting bottlenecks are also an issue; the PJM Interconnection approved only 0.4% renewable power capacity applications in its queue over the last five years, while California curtailed 5% of its utility-scale solar production in 2020 due to insufficient transmission capabilities.[4,5]

There is still much to do, but this all gives rise to huge opportunities. The economic and human costs from global warming is massive; annual insured losses regularly eclipse $100 billion.[6] Decisions to combat it are not just the right thing to do but are also being pushed along by influential scientists, regulators, legislators, corporate executives, individuals, and asset owners.

Conclusion

Global warming, climate awareness, and ESG initiatives are having a tremendous impact on how trillions of dollars of capital is being allocated and how issuers are being valued. There are some investors who believe that portfolios with a climate-focus will experience a loss of alpha opportunities. We politely yet strongly disagree with that prognosis.

On the contrary, we believe that those issuers and countries who proactively participate in the journey to a "greener" future will be rewarded. Thus, we believe asset managers who monitor, identify, and invest with them will generate commensurate outperformance. Identifying and monitoring such issuers is, no doubt, a complicated process involving many variables. We firmly believe by implementing both positive selection and negative screening - along with impact analysis and traditional credit research - that we can not only help achieve a positive environment impact but attain long-term alpha as well.

Endnotes

[1] World Economic Forum, Boston Consulting Group. "Winning the Race to Net Zero: The CEO Guide to Climate Advantage". January 2022

[2] Net Zero Tracker https://zerotracker.net/. Accessed 9/7/2022

[3] The pros and cons of ESG screening – ESG Clarity Intelligence (esgclarity-intelligence.com)

[4] Bloomberg NEF. "US Electricity Regulator Hopes to Ease Grid Access Bottleneck to Renewables". 8/25/2022.

[5] U.S. Energy Information Administration. "California's curtailments of solar electricity generation continue to increase". U.S. Energy Information Administration - EIA - Independent Statistics and Analysis. 8/24/2021. Accessed 9/7/2022.

[6] SwissRe. "Global insured catastrophe losses rise to USD 112 billion in 2021". Global insured catastrophe losses rise to USD 112 billion in 2021, the fourth highest on record, Swiss Re Institute estimates | Swiss Re. 12/14/2021. Accessed 9/7/2022.

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