Climate Leadership in Action

Investors shift into low-carbon and climate-resilient assets

At a Glance

- There is increasing evidence that climate change risks constitute a significant portfolio risk for investors—contributing as much as 10% to overall portfolio risk[1].
- However, in the absence of clear, stable policies—such as a meaningful price on carbon—investors will hesitate to shift their strategies.
- Increasing investments in low-carbon and climate-resilient assets is in the mutual interest of governments and investors, but requires bold leadership and a long-term view.
- A growing number of investors are taking steps to integrate climate risk into their investment strategy, for example by tracking carbon exposure. They are also shifting investment strategies to prefer companies with relative lower emissions. In this way, investors are building climate-resilient, greener portfolios.

THE CHALLENGE

To stabilize the global average temperature rise at 2 degrees Celsius, patterns and flows of investment will need to change considerably. In 2013, the World Economic Forum estimated that the US$ 5 trillion that is already flowing each year toward global infrastructure investment needs to be "greened" and an additional US$ 700 billion annual investment is required to address climate change. Institutional investors have US$ 75 trillion of assets under management; today, less than 1% of these assets are allocated to green investments and even less in emerging markets. Unlocking investor capital is critical to addressing climate financing needs.

Climate change presents serious risks to the financial system, with a number of recent studies showing the economic impact that climate change is already having – across all sectors of the economy impacting financial returns and value.

Investors need to adapt to a new reality. As governments put in place increasingly stringent policies and regulations to address climate change, a business-as-usual investment strategy is likely to result in investing in assets that may be prematurely stranded and create financial losses that threaten long-term economic growth.

Adapting to the new climate reality is not only a question of risk mitigation and hedging investment portfolios. An increasing number of investors have discovered new, profitable investment opportunities in low-carbon, climate-resilient projects and companies, leading to financially stronger, more resilient portfolios.

However, to unlock low-carbon and climate-resilient capital flows, a mix of appropriate regulatory frameworks, financial incentives and pro-active investor strategies is needed.

Moving Forward

There is evidence that investors are moving toward low-carbon assets. An increasing number of investors are calculating and publishing the carbon footprint of their portfolios, and others have committed to measure climate risks.

However, this shift is not happening fast enough. Green capital flows are not yet sufficient to address the risks presented by climate change or to meet the investment needs of transition to a greener economy. More finance sector leadership is needed. Leadership can take many forms, including: increasing direct investments in clean energy and climate-resilient infrastructure; creating strategies that allocate assets based on climate performance and actively engage with companies to drive low-carbon behavior; tracking and reporting on the carbon footprint of investment portfolios and advocating more actively for carbon pricing and other proactive government policies. Leadership can also involve divestment of fossil fuel assets that present risks to future performance.

Releasing climate data in corporate filings is an essential step that allows investors, insurers, and lenders to track their carbon exposure and shift their investment to a greener portfolio.

Financial market regulation is also critical to change capital flows.

Early this year, the UNEP launched an Inquiry into policy options for guiding the global financial system to invest in the transition to a low-carbon, green economy. Initial results of the Inquiry will be delivered in 2015. In South Africa, the Pension Fund Association has established standards for how to take environmental, social and governance factors into their investment practice embedded in the pension funds law (Regulation 28 of the Pension Funds Act, 2011). Similarly, 11 stock exchanges have publicly committed to promote sustainability in their markets and have become a Partner in the Sustainable Stock Exchange Initiative.

Examples of Leadership

Investors representing trillions of dollars of assets under management have endorsed the 2014 Global Investor Statement on Climate change, demonstrating that they realize that climate change will undermine the financial gains of their portfolio and have begun rethinking their investment strategies and practices.

Some of the encouraging trends that we see are:

1. Investors shift allocation to low carbon: Some investors are increasing their allocation to low-carbon and climate-resilient assets, thereby playing a vital leadership role in financing the transition to a low-carbon, climate-resilient economy.

* The Danish pension fund Pension Denmark has approximately 9% of its assets allocated to low-carbon investments, the Australian superannuation funds--Local Government Super Scheme, Catholic Super and HESTA--have approximately 8% in low-carbon assets, and the UK Environment Agency Pension Fund is on track to have 25% invested in companies and assets that make a positive contribution to low-carbon and climate-resilient economy by 2015.

* Green bonds are mobilizing private sector financing for climate-smart activities and as the market expands from development banks to cities, corporates and utilities, green projects will benefit from a broader institutional investor base.

2. Investors improve carbon measurement and transparency to reduce portfolio emissions and fossil fuel exposure: The industry is collaborating to improve carbon measurement and climate change risk disclosure by companies and by the finance institutions themselves, an essential step that allows investors, insurers and lenders to track their investment.

* A growing number of investors measure and track their carbon footprint as a way to manage the climate risk of their investment portfolio. CDP requests information on GHG, energy use and the risks and opportunities from climate change from the world's largest listed companies on behalf of 767 institutional investors with US$92 trillion in assets.

* The Swedish pension fund AP4 and French asset manager Amundi are implementing new techniques to decarbonize investment portfolios across passive equity portfolios

* Fund managers such as PAX World, Blackrock, Climate Change Capital, Dexia, Generation Asset Management, Impax, KBC, Pictet, Robeco, SAM, Sarasin and WHEP, among others have developed investment products to invest in companies that make a positive contribution to addressing the climate change challenge.

*A number of pension funds have capped their exposure to fossil fuel, and the Australian superannuation fund HESTA has decided to divest all of its investments exposure to thermal coal assets.

References and suggested reading

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1 Mercer: "Climate Change Scenarios – Implications for Strategic Asset Allocation" (2011)