

# IEN Q&A: Managing Public Equity Portfolios through a Climate Risk Lens

As the systemic financial risks posed by climate change become increasingly apparent, the need to address the potential impacts of environmental shifts has become that much more imperative. In November 2019, Federal Reserve Governor Brainard noted that the Fed must consider climate change when contemplating monetary policy. Further, in September New York state's financial regulator joined the Network for Greening the Financial System (NGFS), a global coalition of 46 central banks and regulators dedicated to address climate change. Nearly \$20 trillion in global assets are at risk if a timely transition to a low-carbon global economy fails, according to the NGFS.

Given the global equities market capitalization was nearly \$75 trillion in 2018, according to SIFMA, the [Intentional Endowments Network](#) approached public equity industry experts regarding their perspective on the impact of climate change on equity portfolios. Such investors included:

- **Anthony Rust**, Investment Committee Chair, **Warren Wilson College**
- **Amberjae Freeman**, Chief Operating Officer, **Etho Capital**
- **Habib Subjally**, Senior Portfolio Manager and Head of Global Equities and **Ben Yeoh**, Senior Portfolio Manager, **RBC Asset Management**

## IEN: HOW DOES CLIMATE CHANGE IMPACT YOUR PORTFOLIO?

**Rust:** All companies in our public equity portfolio are subject to transition risk related to changing public policy and regulations, technological advances, and company reputation, and physical risks related to acute events such as floods and hurricanes as well as chronic factors like the impact of gradually rising temperatures on an industry. Climate risks exacerbate current risks to a company. For example, effective water management will always impact the success of a beverage company, but as areas become more water stressed as the globe warms, that water management becomes increasingly difficult and calls for a company to be more innovative and proactive in its strategy. Climate change also presents opportunities in resource efficiency, new products and services, new markets and resilience planning.

**Freeman:** Climate change impacts all portfolios because every species on the planet needs fresh water, arable land, and breathable air to exist. Additionally, private enterprise relies upon natural resources and labor to create products and provide services to generate profit. Essentially, economic growth and sustainability are interdependent. It is not possible to have sustained economic prosperity without the efficient management of natural resources. We understand this fundamentally and take pains to shore up our portfolio against climate change risks by evaluating companies on how well they are able to manage their use of natural capital resources.

We minimize the risk from climate change to our investors and the broader society is to identify companies and industries that either a) develop products and services to create solutions to the climate crisis. Or, b) conduct their business activities in a way that minimizes the negative impact of their operations on the environment. We do not invest in the fossil fuel industry and other industries our research has shown to be unsustainable. We use climate pollution as a powerful indicator for overall operational efficiency and competitive advantages, across all industries and sectors, because greenhouse gas emissions are connected to nearly every part of every company's supply chain.

That is why we look at a company's environmental impact across their entire supply chain.

**Subjally/Yeoh:** There are several intersectional risks and opportunities. These cover transition, adaptation and resiliency risks and the second order effects such as policy and geopolitical risks. It covers systemic thinking covering "sunset" declining industries and "sunrise" growing industries. It impacts every individual company across the range of activities and assets it has.

## **IEN: HOW DO YOU APPROACH ADDRESSING THE RISKS PRESENTED BY CLIMATE CHANGE IN YOUR PORTFOLIO?**

**Rust:** Warren Wilson College has divested from companies with the greatest fossil fuel reserves, both because they are antithetical to our mission to "prepare graduates to ... lead purposeful lives dedicated to fostering a just, equitable, and sustainable world" and because we believe that those reserves are overvalued, and likely to lose value as the global community moves to address climate change. With the exception of emerging markets equity where we have taken a quantitative fossil fuel free approach, we invest passively, using separate account managers who will optimize to a selected benchmark after removing the companies with the greatest fossil fuel reserves from the portfolio. We use traditional market benchmarks to assess the performance of these investments. To date, the passive portfolios have performed in line with their benchmarks since the inception of our investment, and the emerging markets portfolio has slightly outperformed its benchmark.

**Freeman:** Sustainability and financial performance are linked. Applying this assumption to the financial markets we posit that climate efficiency and financial performance are also linked. This suggests that an optimum climate efficiency level should exist for maximizing risk-adjusted returns. We construct our indices and our portfolios with this relationship in mind and have found that in most cases when climate efficiency rises the overall risk-return profile improves.

**Subjally/Yeoh:** In our strategy, we are fundamental bottom up. We look at the material extra-financial and financial impacts and opportunities presented to every single company we own for climate and any other environmental, social, governance and business risk/opportunities. We make a materiality assessment and then embed our view into an analysis of the company

and then into its valuation on a long-term outlook. This may include scenarios including carbon tax or other policy responses, as well as considering of innovation, supply chain, human capital, social capital and other intangible assets or liabilities. We also perform carbon footprint assessments.

## **IEN: CAN YOU SHARE CHALLENGES TO ADDRESSING THE IMPACT OF CLIMATE CHANGE ON YOUR INVESTMENTS? IS THERE ANY ADVICE YOU CAN GIVE TO INVESTORS CONSIDERING SIMILAR RISKS?**

**Rust:** Climate change risk exists in every sector of the economy, so while we have divested from companies with the largest fossil fuel reserves in our public equity portfolio, we know that the portfolio is still exposed to climate change risk in other industries. The data available to investors to assess that risk has improved but is still inadequate. This year we are beginning to address that challenge by embracing our role as active shareholders of the companies in which we invest. We have been collaborating with the Intentional Endowments Network and their partners to co-file resolutions requesting better disclosure around climate risk and accountability on the part of the board to address the climate risks of the companies they steward. We will also be voting our proxies consistent with our responsibility as owners of the companies in our portfolio to increase transparency and accountability not only around environmental risks but also around diversity.

**Freeman:** Human activity has an impact on the environment - this is the central challenge that we all face in addressing the impact of climate change on our investments. In our view, the growth and preservation of capital are predicated on our ability to reform markets to address our societal needs while considering all costs to all stakeholders - which includes planet and people.

We use both quantitative and qualitative screening methods to further refine our portfolios by removing unsustainable companies and industries (like coal, oil, natural gas, tobacco, weapons, gambling, etc.).

The task for society is to determine the optimal level of economic activity needed to satisfy our water, energy, food, housing, and waste management needs without completely compromising ecological systems and the natural capital that produce them. The opportunity for our investors is to make money off this transition. In order to achieve both our economic and environmental objectives, we will need to allocate capital toward products and services that can do and provide more with less.

**Subjally/Yeoh:** The data and understanding of the issues are still in its early days. For instance, an understanding of how Scope 3 Carbon impacts\* might be assessed; what type of carbon prices to use and where and what a policy response might be are all challenges to address. One starting point for investors could be by understanding the fundamental risks and

opportunities, what the science is saying and an overview of likely policy responses. The TCFD\*\* is a good starting framework to be familiar with.

## IENT: HOW DO YOU MEASURE SUCCESS?

**Rust:** As mentioned earlier, we measure the performance of our portfolio against traditional benchmarks. For the global equity portfolio that is the MSCI ACWI IMI. We also measure our success by the ability of the endowment to support the college's mission. Financially we support the mission by supporting the operations of the college. We also support that mission by engaging students, faculty, staff and administrators in our ESG Advisory Committee which makes recommendations to the investment committee and is currently learning what it means to be an active shareholder, thereby helping our students and the rest of our community "foster a just, equitable and sustainable world."

**Freeman:** We measure success through our portfolio performance.

We aim to leverage the financial markets for the benefit of our clients and the broader society to shape a more prosperous and healthy future for all stakeholders into perpetuity. I often tell people, "Creating, sustaining, and protecting resources so that they may be used for the benefit of shareholders now and into the future is the essence of asset management."

We are asset managers at Etho. We understand the meaning of the word 'perpetuity.'

**Subjally/Yeoh:** In 50 years, I sincerely hope I can tell you we still had a world worth living in.

For today, much of our work centers around stewardship and engagement, convincing senior management and boards of companies to take the risks and opportunities seriously.

\* - for more on Scope 3 emission standards, visit <https://ghgprotocol.org/>

\*\* - for more on the Task Force on Climate-related Financial Disclosures, visit <https://www.fsb-tcf.org/>