17th September 2021

Enabling climate transition: the path to net zero

- Transitioning to a low-carbon economy is critical
- 'Green-washing' is a problem
- Selection methodology is key

"A code red for humanity. The alarm bells are deafening and the evidence is irrefutable."

UN Secretary General Antonio Guterres discussing the most recent Inter-Governmental Panel on Climate Change (IPCC) report published in August 2021.

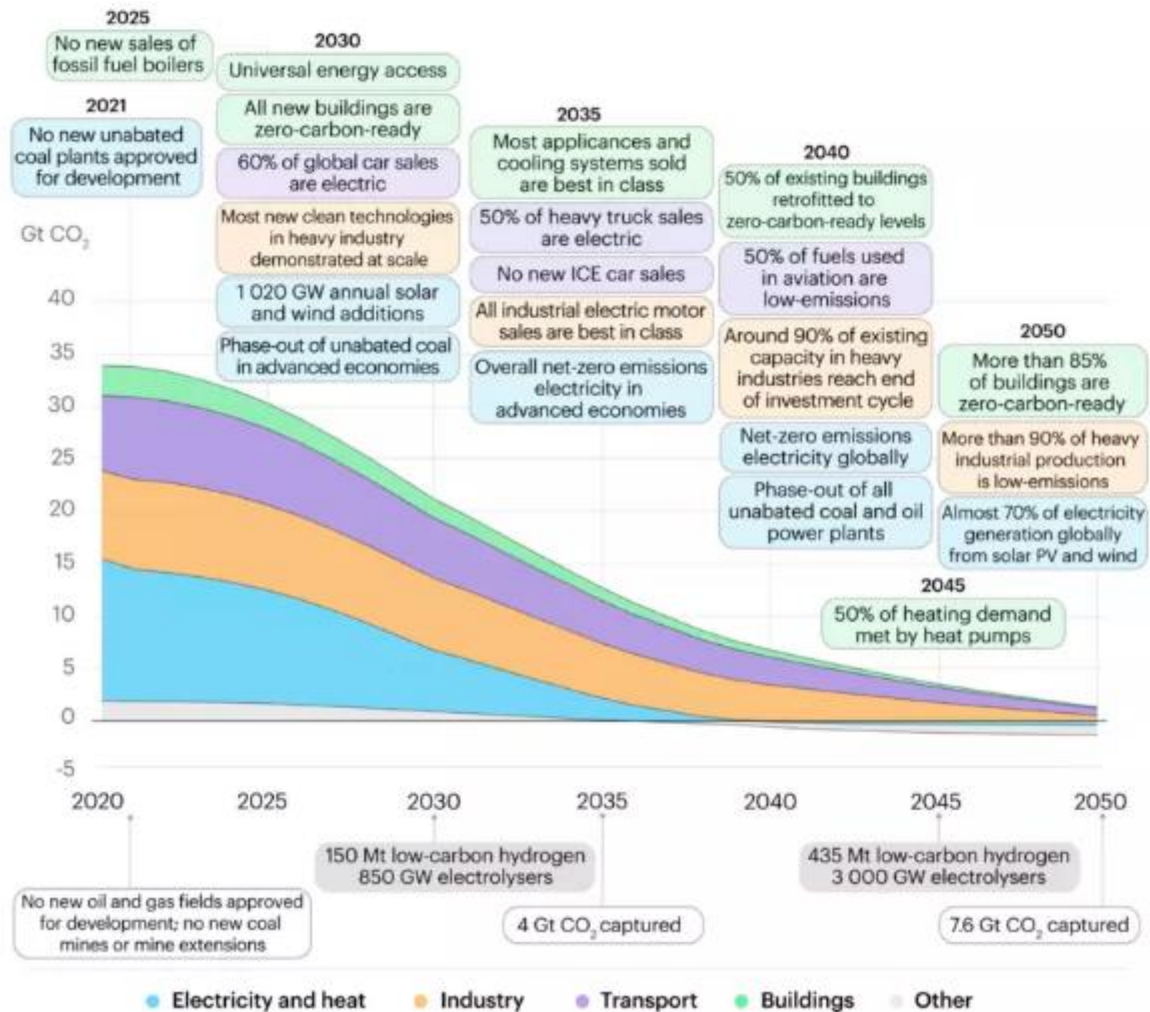
An urgent age of transition

The most recent report from the Intergovernmental Panel on Climate Change (IPCC) highlighted the necessity of limiting global warming to 1.5 degrees in order to address the risks associated with long-lasting or irreversible changes to the earth's atmosphere and ecosystems. The Paris Agreement went further, citing 2 degrees as the necessary target and there are suggestions now that even this may not be enough. While policy commitments are plentiful, however, policy responses have yet to catch up.

The concept of Net Zero refers to a point where carbon emissions entering the earth's atmosphere are equal to the amount of carbon being removed from the atmosphere by any method. For Net Zero to become a reality, a massive scaling up of new and early-stage technologies will be required in order to prompt wholesale changes in the way that energy is generated, stored, transmitted and consumed. Investors and the direction of capital flows will play a huge part in the attempt to bring this about.

The path to net zero

The path to net zero will take a number of steps and changes in energy use, storage and capture, an illustrative roadmap is set out below.



Source: IEA

Adapting investment strategies

Transitioning to a more sustainable economy requires investment products that can deliver on the SDGs (sustainable development goals), the Paris Agreement and the ambition to be climate-neutral by 2050. The SDGs are an internationally recognized set of goals, targets, and indicators developed by the UN to guide the global development agenda through the coming decade.

Whilst focusing on firms, including energy firms, that are themselves targeting to become Net Zero is positive, there is a further and significant opportunity to support the companies that are developing climate solutions that will actively enable that transition to Net Zero, as well as benefitting from this new persistent trend. Specialist clean energy research firm Longspur describes these types of companies as those with an "Active Net Zero®" approach.

The green-washing problem

As the development of a sustainable economy becomes ever more imperative, financial sector stakeholders have an important role to play in determining how this evolves. As socially-responsible investing has gained traction over the years, investment opportunities carrying green credentials have become increasingly desirable to investors both from a moral standpoint and – as time has gone on – a financial one. Driven by this mounting appetite, it is perhaps to be expected that in many instances, behind the green, clean façade, all is not what it seems. A lack of universally agreed regulation, robustly enforced and applied across sectors and jurisdictions and has left any number of loopholes open to exploitation.

In some apparently "green indices" and/or "green funds", you may find companies with significantly less green credentials. This can be owing to methodology differences, from manager decisions, or indeed from credentials presented to investors by the underlying companies. This can be accidental or deliberate "greenwashing", the presentation of unsubstantiated or exaggerated claims that an investment is environmentally friendly.

As the number of ESG retail funds grows, and to help protect investors from the risk of greenwashing, the Government is establishing a Green Technical Advisory Group (GTAG) which will oversee the Government's delivery of a "Green Taxonomy" – a common framework setting the bar for investments that can be defined as environmentally sustainable[1].

The importance of robust and representative methodology

The methodology that governs indices (and hence those funds that track them) deserves detailed analysis. There are a number of clean energy indices available, but their methodologies differ. Key focus areas of comparison, or any index, include: equity universe (regional/global), rebalancing frequency, weightings scheme, liquidity constraints, min/max position sizes, and constituent count. However the key methodology comparison for clean energy indices is around selection criteria for inclusion within an index. This could be based on % of revenues or market value that relate to clean energy or carbon transition technology. But how to adjust for and differentiate carbon-intensive energy companies that are also investing in clean energy? The efficacy of accessing clean energy exposure using a Clean Energy index is a function of the quality of assumptions and methodology underpinning these selection criteria.

[1] https://www.gov.uk/government/news/new-independent-group-to-help-tackle-greenwashing

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Incorporating a Net Zero approach into a portfolio

For advisers looking to incorporate a Net Zero approach into a client portfolio, where ESG preferences are high, we would advocate a three-step approach.

1. Understand the Carbon footprint of your existing portfolio
2. Consider how substitutions of traditional with ESG-screened funds could reduce that Carbon footprint
3. Consider whether, and to what extent, an allocation towards climate solutions, which by their nature may be higher risk investments, will actively contribute to achieving the path to net zero.

A bias towards ESG and a moderate investment in climate solutions, can help achieve those objectives for those clients who seek climate-oriented values in their investment portfolio, as well as their day-to-day living,

Henry Cobbe & Marina Gardiner

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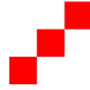

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