J O Hambro
Capital Management Group

News

Decarbonisation Dilemma

If climate action is not to fail, then change is required.

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The need for climate action is in sharp focus for investment teams at JOHCM. The World Economic Forum ranks climate action failure as the most severe risk on a global scale over the next ten years.* While world leaders collectively recognised the urgency of this challenge for the first time at the COP26 climate summit, the plans submitted failed to provide a decisive pathway towards keeping the global temperature increase below 1.5˚C. World leaders have been asked to revisit their plans and strengthen their 2030 targets by the end of 2022.**

If climate action is not to fail then change is required, and that change must come from across the global system, not just from regulation. As Paul Hawken writes in his recent book, “The climate crisis is not a science problem. It is a human problem.”*** Investors must encourage their companies to change, and companies must understand that they need to change if they are to survive. As Jack Welch once said, “Change, before you have to.”

At JOHCM, the independence of our fund managers is at the core of our culture. It is through freedom of thought and the power to act on original analysis, that talented investors can best make a difference for our clients on systemic issues such as climate change. While climate change and the need to transition to a net-zero carbon economy run through decisions on all our funds, how evidence is framed, analysed and interpreted differs from one fund to another, in some cases radically. Here we look at how three of our funds approach the issue, each working from a verydifferent viewpoint.

JOHCM UK Dynamic Fund

The UK Dynamic team focus on “investing in change” with a track record established in understanding the likelihood of successful management and strategic change: the identification of sustainable change. Decarbonisation requires nearly all companies to change, so this sits naturally as a central theme affecting the portfolio. The team sees the ability of a company to manage sustainable change as being determined by its mindset. Understanding a company's sustainability mindset requires analysis of the complex interplay of quantitative and qualitative information drawn from looking at an organisation's purpose, its people, its processes, and assessing how these enable it to fit into its wider eco-system. The team believes it is companies that look to fit their wider eco-systems that are best placed to adapt and evolve into sustainable leaders of the future. Sustainable leading companies are those evolving the right mindsets for tomorrow, rather than just those with the right sustainable credentials today. The team has developed a proprietary Mind Set Evaluation (MET) framework, which seeks to capture much of this analysis. Climate-related risk assessments are integrated throughout the MET framework. Analysis begins with an assessment of an investee company's risk exposure, by assessing current GHG emissions in both absolute and relative terms. To understand a particular company's level of risk exposure, the team makes a relative assessment with reference to the investible universe (FTSE All-Share). Companies that fall into the highest cohort of GHG emitters within the investible universe are considered to be at high risk.

To understand how a company is managing this risk, the team seeks to understand:

1. 1. What commitments and progress a company has made in reducing its GHG emissions across all scopes (for example, the company is committed to setting or has already set a Science-Based Target, has implemented and is disclosing progress to achieving short, medium and long-term GHG reduction targets, and the company is on track to achieving its GHG reduction goals).
2. Whether the company makes disclosures in line with recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), conducts analysis in line with a 2˚C or 1.5˚C degree scenario to quantify impacts, and submits regular data to CDP, with a view to improving scores over time.

The team performs deep qualitative assessments of company TCFD reports and transition plans to gain insight into where climate change risks and opportunities can manifest, and what strategies are in place to manage these risks or take advantage of the opportunities. The more advanced companies are those that integrate the learnings from their climate scenario analysis directly into their climate strategy and financial forecasts.

The team also factors governance mechanisms into the assessment,with the best-performing companies having board oversight of climate risk, linkage of climate targets to executive remuneration schemes, and a strong sustainability governance framework in place. Strong accountability mechanisms bring validation to a company's climate risk management strategy. The approach has led to a portfolio in which over 70% of the capital is either signed up to the Science-Based Targets initiative (SBTi) or actively working towards signing up. It has also resulted in a schedule of climate action related engagements, focused on the relatively low number of companies in the portfolio where the team feels progress could be meaningfully accelerated.

JOHCM Global Opportunities Fund

The Global Opportunities team views climate change as one of several key areas where shareholders have a responsibility to encourage companies to behave in a way that results in positive outcomes, including the reduction of adverse impacts. Any way in which a company can be perceived to be responsible for a negative impact, by acting against the interests of non-equity stakeholders, presents a risk to shareholder value. Companies which are "part of the problem", not "part of the solution" to climate change, will find themselves the wrong side of regulators, legislators and ultimately their own customers. The team's approach to sustainability emphasises the need to focus on areas of harmfulness and engage with companies about their direction of travel and their commitment to improve. It incorporates these factors into a proprietary Sustainability Score, which takes a multidimensional, forward-looking and company-specific view, rather than relying on backward-looking metrics or third-party ratings, or applying blanket sector-wide exclusions. This Sustainability Score underpins its engagement activities and forms the basis for certain stock-specific exclusions. It actively seeks to invest in agents for positive change, which can sometimes involve investment in what are regarded as controversial sectors.

The team's forward-looking approach, and awareness of the importance of investing in agents for positive change among larger, often incumbent, companies, means that it will sometimes invest in what are regarded as controversial sectors. With regard to climate change, for example, it sees the regulated utilities sector as both critical drivers and also beneficiaries of the need to reduce global carbon emissions from power generation. It is willing to invest in utilities with worse-than-average carbon footprints, for example, but only if management has committed to a clear roadmap to reducing this, with quantifiable targets and milestones, ideally incorporated into management remuneration schemes to ensure accountability.

Its engagement activity typically focuses first on disclosure and then on emission reduction targets. An example of a recent engagement was with the Texas utility, Atmos. The team has had regular communication with senior management, both formal and informal. It has specifically asked that the company adopt holistic carbon targets, rather than just for methane, and that management remuneration be linked to achieving those targets.

Regnan Sustainable Water and Waste Fund

The Regnan Sustainable Water and Waste Fund invests in water and waste-related solutions, and the team understands that sustainably decarbonising the economy is important, and that adaptive solutions to physical manifestations of climate change are necessary for the smooth functioning of economies. As in other sectors, decarbonisation offers opportunity as well as risk. Disposal of waste and treatment of wastewater are inherently relatively high carbon-intensive processes. For example, companies can reduce their dependence on fossil fuels by increasing fleetefficiency through alternative fuels and electrification, and route optimisation. In addition, emissions such as methane generated in the waste management process can be captured to produce energy for transport and electricity.

The team factors governance into the assessment of climate risk. Company-level consideration of climate risks within the Regnan Sustainable Value Assessment (SVA) framework takes an exposure (what is the exposure of a given company to an issue) and response (what is the company doing about it) approach. The SVA on climate change includes both transition and physical impacts of climate change. Few of the factors taken into consideration include: an understanding of the emissions profile, exposure to carbon regulatory schemes, strategic recognition of key aspects of transition risks and opportunity, mitigation action the company is undertaking in relation to transition exposures, and monitoring of the evolution of transition exposures over time.

The team takes the view that the transition to net-zero is a gradual process and that end-goals will not be achieved overnight. As a new fund, launched only in September 2021, there is no history of engagement at this point. The planned approach is to focus on change and to track progress. The expectation is to prioritise companies highly exposed to transition risks, especially in areas where related risks are seen as inadequately managed.

Sources:
* World Economic Forum's Global Risks Report 2021
** https://www.wri.org/insights/cop26-keyoutcomes-un-climate-talks-glasgow
*** Regeneration – Ending the climate crisis in one generation (Paul Hawken, 2021)

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