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Practical pathways to net zero

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Investors increasingly recognise the urgency of addressing climate change and reducing the environmental impact of their investments. Many, particularly in the institutional investor space, have already set net zero goals and commitments. But how can good intentions be translated into effective action?

Fast reading:

- There is no silver bullet for investing in the climate transition, however, common to all approaches is the need to understand the challenges and address a range of obstacles.
- The best solution combines strong historical data with forward-looking tools including scenario analysis, sector decarbonisation pathways, technology curves and projected emissions.
- Qualitative research and direct engagement with companies are valuable adjuncts to quantitative analysis, and any approach will need to be revisited as the macro environment evolves.

Beyond carbon frontiers

Asset owners and managers employ a range of available frameworks to assess the alignment of their portfolios with the climate transition. However, the current focus tends to be more on the intended outcome in terms of lower emissions intensity than on the necessary path to get there. With most of the initial goals for carbon reduction set for 2030, practical implementation of net-zero strategies by asset owners is still limited. To take the next step, investors need to be able to address and overcome the practical challenges and obstacles that still exist.

Having managed an ESG strategy since 2012, we believe our thinking on the issue within the Global Equities team is more evolved and sophisticated than that of newer entrants to the market. Here we will set out our practical approach to investing in the climate transition.

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No silver bullet

It is important to note that there is no single answer to the climate challenge; depending on the needs of underlying beneficiaries and the level of risk appetite, different approaches will be required. Some will want to take an exclusionary approach, while others will seek to participate in the transition, seeing it as a glide path to a low-carbon future. Common to all, however, is the need to understand the challenges and address a range of obstacles to decarbonising and futureproofing portfolios by investing in climate solutions.

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Considering the full risk and return spectrum of investment opportunities is part of our fiduciary duty. Climate risks are becoming more prominent, not only in terms of volatile fossil fuel prices but also in terms of physical risks such as changing weather patterns and extreme weather events.

Ideally, individual companies should have their decarbonisation strategies mapped out. However, depending on sector and market, firms may experience more or less regulatory push to address the issue and are at different starting points. For example, China is focused on 2060 rather than 2050 as a target date for net zero. Meanwhile, in Japan, coal is still more than 20% of the energy mix (as at 2022).

At the same time, countries want to secure their energy future in the face of an uncertain geopolitical environment, creating shifting demand dynamics that are difficult for firms to adapt to. And while technologies such as carbon capture and storage (CCS) and green hydrogen are developing quickly, they remain relatively untested at scale. Companies may therefore be tempted to delay capital investment.

Meanwhile, despite regulatory support for low-carbon technologies, consumer demand is also a factor. Uptake can be affected by inflationary pressures and other issues, impacting progress – as has been seen with electric vehicles (EVs) in 2024. Inconsistent signals at a political level can exacerbate the problem, with the rollback of targets and regulation for EV uptake in the UK being a prime example. This makes it difficult for businesses to plan into the future.

Finally, understanding, materiality and communication are further key challenges. While stakeholders may want to be granular, this can challenge their time and resources – however, the situation is complex and there are no shortcuts to understanding. Investment constraints set today may be inappropriate in three or five years' time as the market evolves.

Figure 1: The challenges and obstacles to decarbonising portfolios add complexity to investing

The challenge

- Fiduciary duty
- Range of viewpoints and goals
- Low carbon / Paris-Aligned / Net Zero / Transition

- Communication
- Understanding
- Materiality

- Dynamic demand environment
- Regulatory uncertainty
- Time horizon

The obstacles

- Implications for performance
- Implications for risk
  – Alternative "benchmarks"
    – Style biases, purely rules based, made to minimise risk versus standard benchmark
- What are the trade-offs?
  – How far can you push the constraints?

- Immature data sources
- Scope (beyond carbon)
- What to measure
- Greenwashing

At a practical level, we need to consider the impact of all these challenges on portfolio performance. For environmental factors, historic performance is unlikely to be representative of future performance. It is therefore important to use forward-looking data, tools and frameworks to assess companies, combining this with qualitative analysis to challenge modelled outcomes.

Similarly, for risk, we can aim to measure the impact of different environments, or use alternative benchmarks. These are usually designed to minimise risk compared to the standard benchmark, and can have style biases or be purely rules based (and backward-looking) – although we question the validity of this latter approach.

Inevitably, there are trade-offs involved. Taking out names to remove carbon will have implications, whether positive or negative, while pursuing net zero may require adding in sectors such as nuclear power that investors might otherwise exclude. Many green investment opportunities maintain a 'brown' exposure as they pursue cleaner business opportunities.

Ultimately, in assessing a company's overall carbon impact, merely focusing on a company's direct (owned) carbon emissions is insufficient. Scope 3 and even Scope 4 (avoided emissions) are also important, as are related issues such as impact on nature and water use. However, data and understanding of these aspects remains immature. The majority of Scope 3 emissions are modelled. This leaves the door open to greenwashing around issues such as offsets, with companies failing to back up published targets with verifiable action.

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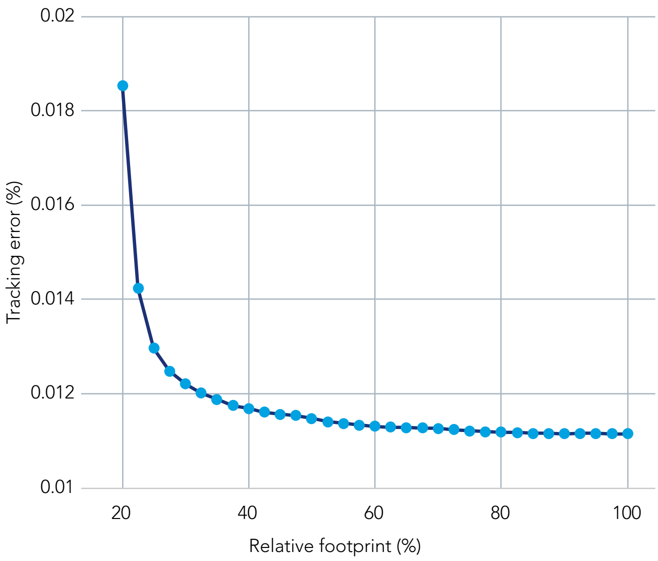
The risk impact of carbon reduction

In terms of creating risk, our research shows that the impact on tracking error of a reduction in the carbon footprint of a portfolio of up to 50% is limited. Figure 2 shows an example based on a portfolio relative to the MSCI World Index that addresses a relative reduction in Scope 1 and 2 emissions while targeting maximum risk-adjusted return.

Figure 2: The impact of up to 50% carbon reduction on tracking error is minor



Source: Federated Hermes Global Equities, as of 30 April 2024.

We would caveat, however, that this is a single metric reflecting latest available emissions intensity and, in our view, should not be the main focus for investors. This data is often significantly lagged and doesn't offer a comprehensive picture of the climate risk that companies face. There are companies in hard-to-abate sectors whose carbon footprint is sizeable but who will be critical to the success of the carbon transition as they decarbonise over time. These climate solutions companies are enablers for the rest of the economy.

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50% is limited.

The way forward

Despite the obstacles, we believe these challenges are resolvable. In our view, the best way forward involves a multi-pronged solution:

- **Select robust data:** Stay informed concerning available data and select the most robust sources in terms of process, chronological depth and breadth of coverage within a sector.
- **Employ a holistic approach:** Combine a range of available data into a single metric that can be used to compare across sectors and regions. Social and Governance metrics should also be considered.
- **Use forward-looking estimates:** Where available we use forward-looking data, such as information available through our direct engagements with companies regarding how they are positioned to manage future risk or progress with transition plans.
- **Utilise the best tools:**
  - **Scenario analysis:** Assessing companies' alignment with limits to temperature rise.
  - **Sector decarbonisation pathways:** Starting points for sectors differ and not all will decarbonise at the same rate.
  - **Technology curves:** Understanding the direction of travel for key abatement technologies while being aware of current limitations.
  - **Expected emissions:** Modelling a firm's future emissions based on available evidence can be more effective than using backward-looking data, since companies may change in terms of both scale and focus.

Going beyond the numbers

While models are useful, they have their limits. We therefore overlay quantitative analysis with qualitative processes to sense check numbers, assess methodologies and identify firms whose real-world situation may differ from that indicated by the statistics.

We use multiple metrics across environmental, social and governance factors to measure both level (in terms of existing policies, processes and performance) and change:

- **Policies and processes:** What does the company claim?
- **Real-world performance:** What is the reality?
- **Trend:** Is the company improving?

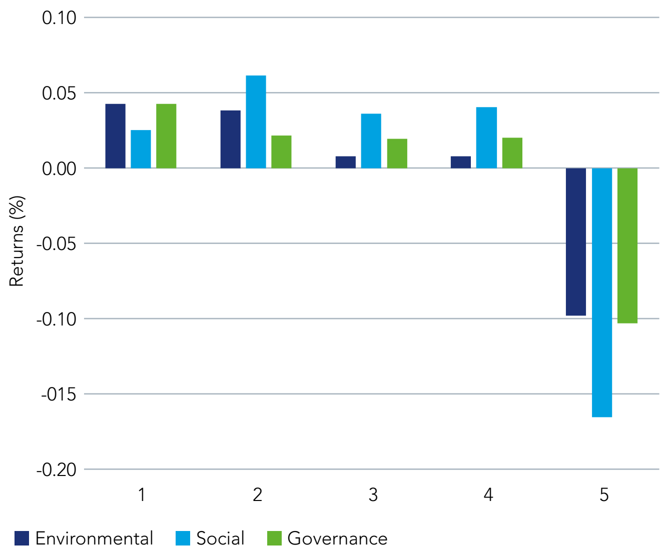
This framework is used to create QE, QS and QG factor scores that summarise companies' environmental, social and governance performance in a single metric.

The performance benefits of ESG

We have been back-testing ESG performance for over a decade, and have published an ESG factor report every two years since 2014. This provides us with robust data to measure the impact of ESG factors on portfolio performance over time.

Our analysis shows that companies with poor ESG practices have historically underperformed the benchmark over the long term. Figure 3 shows 'E', 'S' and 'G' factor returns by quintile for the MSCI World Index between December 2008 and June 2023, with the negative performance of the lowest quintile clearly in evidence for all three factors.

Figure 3: Companies in the lowest quintile for our ESG factors have historically underperformed



The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates. Source: Federated Hermes Global Equities, 30 June 2023. Note: Figures calculated using constituents of the MSCI World index assuming monthly rebalancing. **Past performance is not a reliable indicator of future results.**

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The power of engagement

A key differentiator in our forward-looking approach to investing in the carbon transition is our commitment to engagement and stewardship. We summarise our approach as informed, constructive, purposeful and patient.

Our engagement with companies can be categorised under three key motives:

- **Engaging for insight:** Learning more about a business and its approach to issues.
- **Engaging for risk management:** Pushing for better processes and governance from firms to minimise risk.
- **Engaging for impact:** Encouraging changes to company strategy to directly improve environmental performance.

Federated Hermes sets specific objectives for engagement with companies, such as publishing clear decarbonisation targets or introducing climate expertise at board level. We support these objectives with data-led communication, voting actions, and interaction with industry groups and policymakers. Firms' performance on set objectives is monitored against specific milestones. Lack of progress can lead to escalation – and may ultimately, if no action is taken, result in divestment.

Capturing the green opportunity

Baked into our analysis from which we derive the QE score for companies is an assessment of firms' exposure to sustainability. This covers both positive opportunities, such as renewable power or green financing, and negative exposure, such as unsustainable product offerings or involvement in controversies. We also examine companies' exposure to green taxonomies such as the EU taxonomy for sustainable activities, and to the United Nations Sustainable Development Goals.

At the same time, we recognise that the transition to a more sustainable economy is less advanced than expected, both in terms of the taxonomies themselves and companies' real-world ability to align to them. However, we believe the current ESG backlash is noise, and it obscures the signal, which is the long-term trajectory of the transition to a more sustainable economy.

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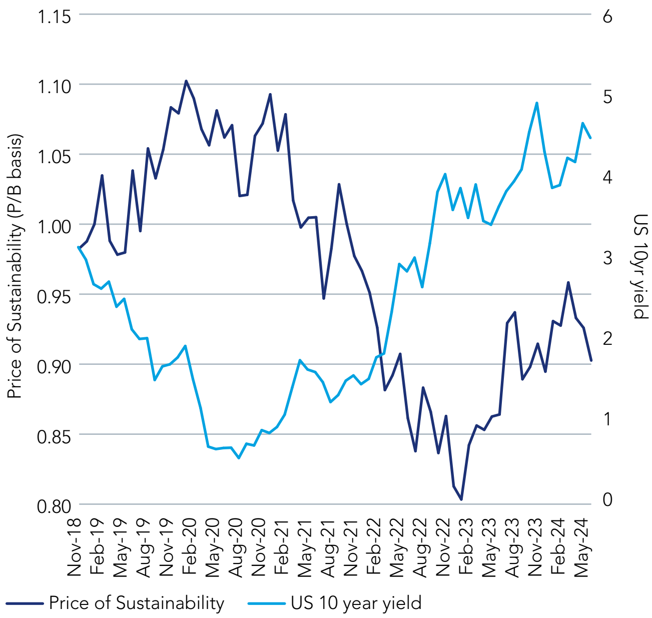
Figure 4 shows the average price-to-book value of companies positively exposed to the sustainability theme over time.

As you can see, these firms became more expensive in 2019-20, but saw a rapid selloff with the ESG backlash, the impact of the Ukraine war, higher inflation and rising interest rates. However, since late 2022, prices have been recovering – while sustainability currently still trades at a discount, we expect this to reverse over time and for the theme to outperform in the medium-to-long term.

Figure 4: With headwinds easing, the price of sustainability as a theme is recovering



Source: Federated Hermes, as of 30 June 2024. **The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results.**

Conclusion

Overall, we advocate a sensible approach to decarbonising portfolios that uses a variety of levers. These may include avoiding or reweighting away from problematic names or weighting towards firms with exposure to the sustainability theme, as well as engaging directly with companies to deliver desired outcomes.

Data and reporting is an important tool to aid understanding, and will be required imminently in some jurisdictions. Ultimately, however, it is important to be data led but not data *constrained*. Qualitative research is therefore a vital adjunct to quantitative analysis, albeit one that requires significant resource to build experience and expertise.

Finally, it is vital to remember that decarbonisation is a highly dynamic theme. Any approach set today will therefore need to be revisited in time as the macro environment evolves.

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