

Is it possible to enhance performance while reducing carbon impact?



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Reducing carbon risk in portfolio construction

Climate change is a core investment consideration - today and for the coming decades. Transitioning to a lower-carbon economy – an economy consistent with limiting the increase in the global average temperature to well below 2°C above pre-industrial levels as outlined in the Paris Agreement - requires further policy action by governments and significant changes to carbon-intensive sectors of the economy, such as energy, utilities and materials. The need to factor climate considerations into portfolio construction is clear. How best to do this is not as obvious. This article looks at two approaches – simple exclusion and imposing intensity based carbon constraints.

Transition risks – a recap

The final report issued by the Financial Stability Board (FSB)-backed Taskforce on Climate-related Financial Disclosures (TCFD) in June 2017 classified climate-related risks into two major categories – physical risks and transition risks.

The transition to a lower-carbon economy necessitates changes to policy, legal frameworks, technology and market dynamics. Governments and companies are already taking action. These changes effectively impose a price on carbon emissions (either direct or indirect). Formal carbon pricing is already in place in over 42 national jurisdictions. Standards on energy efficiency, fuel economy and the phasing out of fossil fuel subsidies will drive further carbon costs. Carbon intensive companies face the strongest headwinds in this transition.

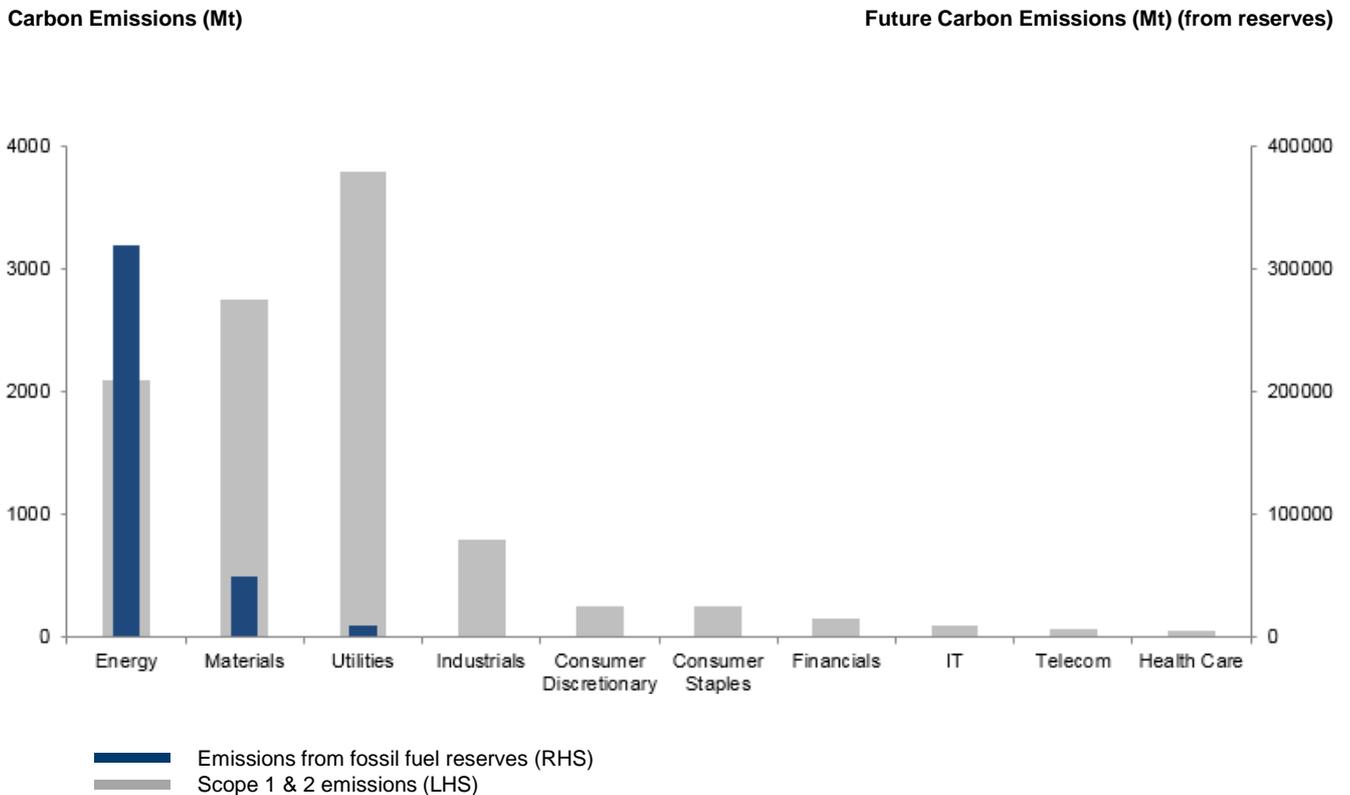


Where is the carbon?

The Greenhouse Gas Protocol provides the most widely used international accounting tool for measuring greenhouse gas (GHG) emissions from corporations. Emissions are classified into three 'scopes' – direct operational emissions (scope 1), purchased electricity, steam or heat (scope 2) and emissions which result from the activities of the company, but occur from sources not owned or controlled by the company (scope 3). In a number of key sectors scope 3 is where the bulk of the GHG emissions are to be found – whether it is in the fuel consumed by cars in the auto sector or the fossil fuel reserves of the oil and gas companies. However, robust scope 3 data is still at an early phase and generally limited to fossil fuel reserves or heavily modelled.

Carbon emissions (scope 1 and scope 2) are highly concentrated in a few sectors i.e. utilities, materials, industrials and energy. Collectively these sectors account for over 80% of the total scope 1 and 2 carbon emissions in the MSCI World universe. The case becomes even stronger when considering fossil fuel reserves (see Fig 1).

Figure 1: Carbon emissions, present and future



Source: MSCI research paper – Beyond Divestment: Using Low Carbon Indexes, April 2015
<https://www.msci.com/documents/10199/031bf397-5920-4fef-b743-0c879ae46610>

Exclusion vs carbon constraints – what do we mean?

As the scale of climate-related risks becomes clearer, investors are adopting different approaches in their portfolio construction.

Exclusion or divestment refers to a narrow or broad-based exclusion of specific sectors. This predominantly focuses on companies associated with fossil fuels – coal, oil and gas. It is worth noting that this approach can be driven by both investment risk and values-based considerations. Fossil fuel divestment first came to prominence following student campaigns in the US demanding their university endowment funds divest from fossil fuels. Public commitments to divest have now been made by faith-based organisations, philanthropic foundations and local governments worldwide. A report from Arabella Advisors in December 2016 found that the fossil fuel divestment movement had doubled over the previous 15 months, with the value of assets held by divesting institutions and individuals now exceeding \$5 trillion.

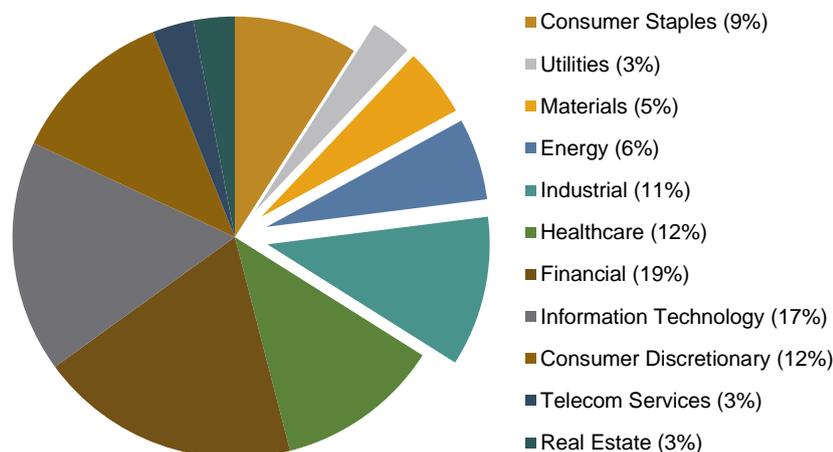
A number of institutional investors have also taken the decision to divest from some fossil fuels – most commonly thermal coal. One example is Norway's largest listed insurance company Kommunal Landspensjonskasse (KLP) which decided in November 2014 to divest from coal companies.

One potential issue we explore with exclusion is that the portfolio performance relative to a more traditional benchmark, for example the MSCI World, may differ substantially (See Fig 3.). As such, clients wishing to maintain their established benchmark may seek solutions that base their strategies on either matching or outperforming their existing benchmark but within strict carbon constraints e.g. targeting a percentage reduction in carbon emissions relative to the benchmark.

Divesting from the energy sector - too high a price?

Carbon intensive sectors face the greatest risks from the transition to a lower-carbon economy but are also where many of the investment opportunities associated with the lower-carbon transition lie. Industrials, energy, materials and utilities are also a substantial component of the market. These sectors collectively represent a quarter of the MSCI All Country World Index by market cap (see Fig. 2).

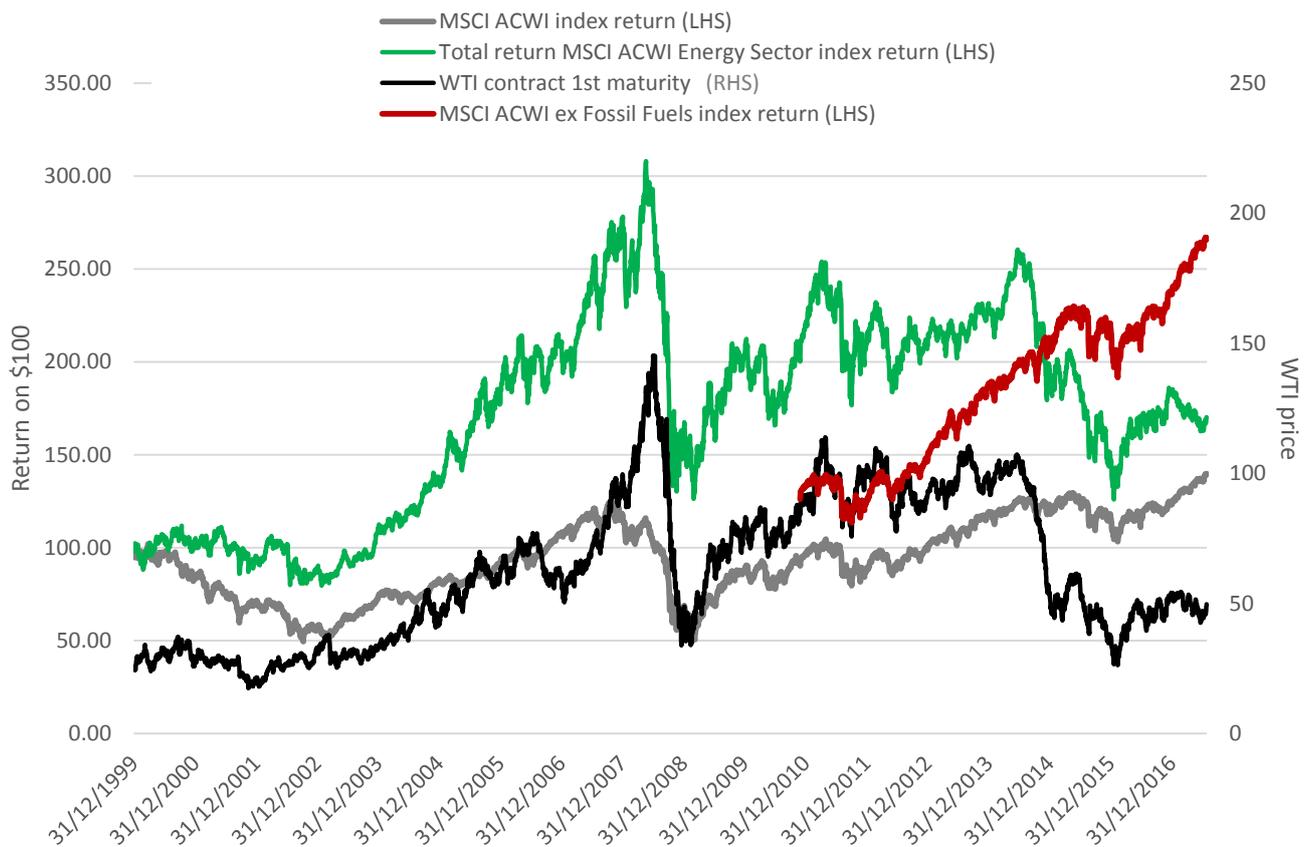
Fig 2. Percentage sector weights by market cap MSCI ACWI (as at 30 June 2017)



Source: MSCI.

Looking only at the energy sector, we can see that its removal introduces considerable cyclicality to returns (see Fig 3). By definition, simple exclusion creates a very different performance profile relative to the benchmark. This can lead to out- or under-performance. Comparing the performance of the MSCI ACWI, MSCI Energy and MSCI Ex-Fossil fuels indices with the West Texas Intermediate (WTI) crude oil price - the underlying commodity of the New York Mercantile Exchange's oil futures contracts – demonstrates the strong correlation with oil price. Hence, simple exclusion of the energy sector introduces additional investment risk that is not compensated for.

Fig. 3 MSCI ACWI, MSCI Energy and MSCI Ex-Fossil fuel index returns with the West Texas Intermediate (WTI) crude oil price



Source: MSCI, Bloomberg and HSBC Global Asset Management as of July 28, 2017.

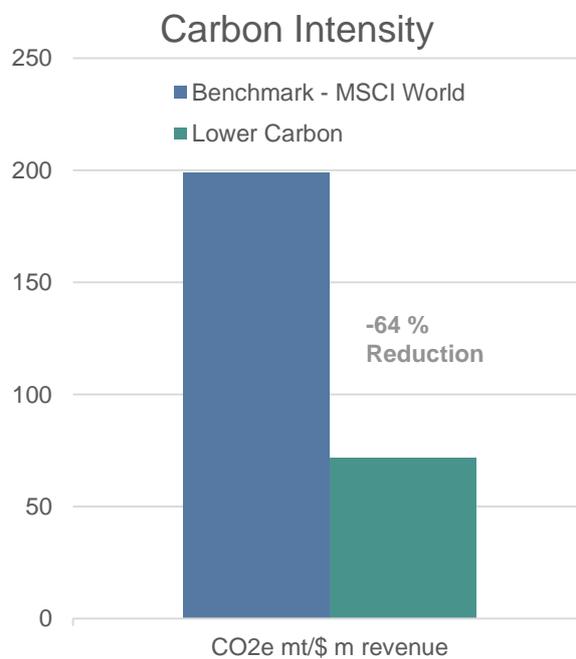
The energy sector is dynamic and many companies are already recognising the need to transition. Drax, currently Britain's largest coal power producer, is an interesting example. It is in the process of converting its facilities from coal to biomass (a renewable energy source with an 80% reduction in GHG emissions compared to coal). It is already producing more electricity from wood pellets than from coal. Any upside from this change in business model will only be accrued to shareholders.

Finally, it is worth reflecting on the value of the vote attached to equity securities. This provides the shareholder with rights, and a responsibility, to hold the management of a company to account. Active stewardship can be used effectively to drive improvements in long-term business strategy and performance. Divesting from a company means the investor has opted out of any potential improvement or opportunity to influence the company to drive improvement. In many cases, long-term shareholders, actively engaging on the issue of climate change, have an important role in encouraging more climate-resilient business strategies and capital expenditure.

Enhancing performance whilst reducing the carbon impact?

Incorporating carbon constraints within portfolio construction can significantly reduce carbon risk exposure (as measured by portfolio carbon intensity) while seeking to generate returns that are better than the benchmark. We modelled a portfolio targeting better than benchmark returns - controlling volatility and tracking error – while delivering less than half the carbon intensity of the benchmark (see Fig. 4). This is achieved by integrating an assessment of the carbon intensity of all stocks into the portfolio management process. This approach depends on the quality and coverage of carbon data and is inherently backward looking, using historic data, but does effectively reduce exposure to the most carbon intensive companies and sectors while limiting biases.

Fig. 4 Relative carbon intensities of MSCI World and equivalent carbon constrained portfolio. Carbon Intensity (tCO2e/USD mn revenue)



Source: Data provided by independent third party carbon data providers, which provide data on every company in the model portfolio. (September 2017)

Conclusion

Managing climate risk is an imperative for all investors. For those investors who are comfortable with some exposure to carbon intensive sectors, imposing carbon constraints may be an effective approach to achieving a lower-carbon risk profile with a return profile in line with or better than the benchmark.



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