COP28: What portfolio managers want to see

Five portfolio managers across asset classes discuss the progress they would like to see at COP28 and its implications.

COP28 is well under way in the UAE and the agenda is packed. Some of the key topics for discussion are addressing the climate financing gap, clean energy targets, nature and biodiversity policies, climate adaptation strategies, and supporting emerging market and developing countries in their climate battles.

Expectations of breakthroughs are relatively low compared to previous years. A number of competing events are vying for political attention, including ongoing geopolitical turmoil and economic headwinds as the world continues to bear the fallout from the global pandemic. However, COP has become a high-profile event capturing the world's attention; addressing climate change is at or near the top of the global long-term priorities, so world leaders will be loathe not to announce some tangible progress.

While the negotiation and hard bargaining continues, for the investment world its clear what needs to be done. We have compiled the thoughts of five sustainable portfolio managers across asset classes to address some of the key agenda items at COP.

Kris Atkinson, Climate Bond portfolio manager, stresses the need for urgency in policy decisions because the progress made today will reverberate for decades to come. Policymakers must quickly create frameworks that effectively channel capital towards sustainable investments, which will not only reduce our carbon footprint but also unlock economic growth across a range of sectors.

Velislava Dimitrova, Climate Solutions and Biodiversity portfolio manager, picks out some of the key areas where she thinks there could be agreements at COP. Renewable energy capacity, energy efficiency targets, updates to the Global Biodiversity Framework and deals around hydrogen and solar power are areas to watch.

Shamil Pankhania, Climate Bond co-portfolio manager, explains why climate adaptation is a crucial part of the strategy to combat climate change. While we still need to continue targeting net-zero by 2050, we must also prepare for the inevitable changes in the climate from past emissions. This requires a two-pronged approach of closing the financing gap and developing clear plans to address the impacts of climate change.

Paul Greer, Emerging Market Debt portfolio manager, discusses the climate change financing gap for emerging markets and developing countries (EMDCs). These countries paradoxically face the most acute effects of climate change yet have the least access to capital to combat these impacts. A robust carbon credit framework and better engagement with private finance are important ways to fund the shortfall.

Julie-Ann Ashcroft, Sustainable Multi-Asset portfolio manager, argues that the evidence of lower costs of capital for green energy projects compared to those of oil and gas shows that investors are willing supporters of the energy transition. However, visibility is key for long term-investors. Reneging on previous goals, changing priorities, and watering down targets sow doubt, so it is crucial that policymakers at COP display strong leadership and unequivocally reaffirm their commitment to net-zero targets.

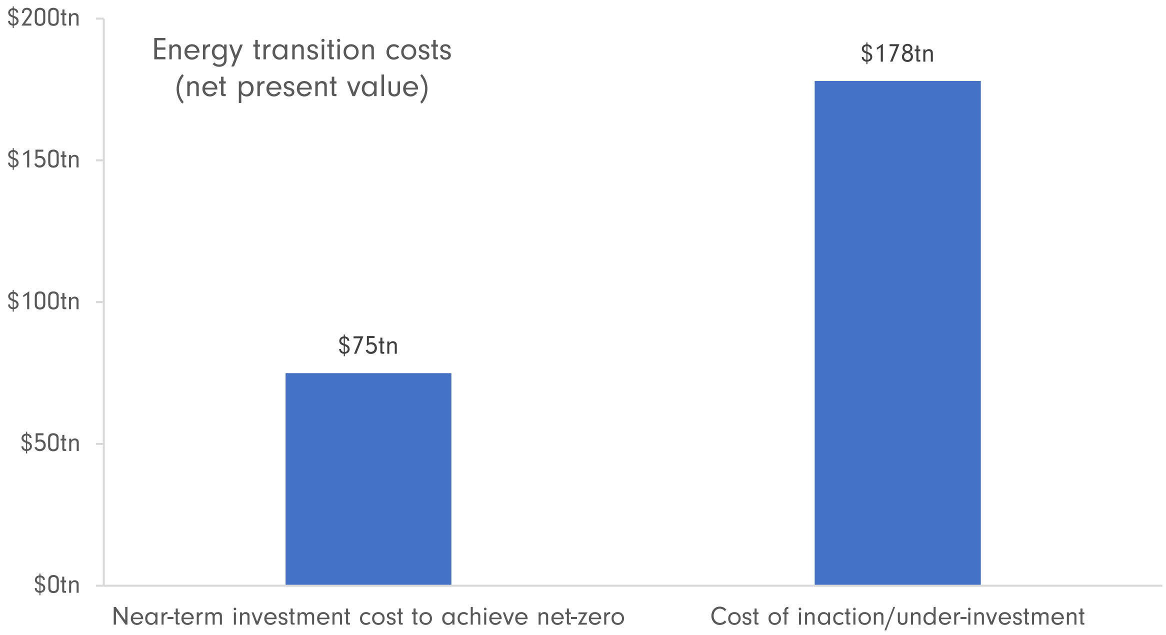
Urgency required to unlock opportunities in the energy transition

Kris Atkinson, Climate Bonds

Transition finance is essential in transforming the economy to a low-carbon one. By supporting the adoption of more sustainable practices, transition finance can mitigate climate change impacts and increase resilience. But policymakers need to step up to help redirect capital towards sustainable investments, thereby creating economic growth while reducing our carbon footprint.

The decisions we make today will shape our efforts in reducing the impacts and future costs of climate change. If we don't do anything it will cost twice as much as preventing or mitigating climate change. While the transition may seem daunting, it presents immediate economic benefits and the realisation of a transformed global economy with lower energy costs and improved environmental sustainability.

Not acting costs twice as much as energy transition ($USD)



Source: BAML, Deloitte, Wood Mackenzie, 2023. Note: NPV of costs to achieve 2050 net-zero versus global costs of climate change effects 2023-2050.

A low-carbon economy requires significant economic shifts and capital spending, especially in sectors where it is structurally hard to abate emissions, which means investing in low-emissions assets and reallocating capital from high-emissions operations to low-carbon alternatives. How to help these sectors decarbonise is expected to be one of the key topics at COP28. Policymakers and investors should act to accelerate the energy transition by supporting the instruments that can fund the evolution of the global economy towards sustainability.

Green bonds are essential for decarbonisation because they are an effective and proven way to finance the scaling up of low-emissions assets. These instruments attract investors looking for sustainable investment opportunities that can develop and expand low-emissions operations. By channelling funds into these projects, companies can increase their capacity for generating renewable energy, producing low-carbon products, and implementing energy-efficient solutions.

The further development of carbon markets is also crucial. These markets help direct capital into initiatives that can prevent deforestation or promote afforestation by financing projects such as sustainable forest management, forest conservation, reforestation, and the implementation of REDD+ (reducing emissions from deforestation and forest degradation) programmes.

Different sectors will be exposed to the transition to varying degrees, and for investors, there will be opportunities. Renewable energy, electric transportation, and sustainable agriculture are likely to experience significant growth. Each of these technologies are surrounded by diverse supply chains, both geographically and sectorally, offering an array of areas for investment and innovation.

Policymakers overseeing the transition need to have a comprehensive view across major economic sectors to understand the current state of these sectors, identify potential barriers to decarbonisation, and develop strategies to address them. This includes a strong grasp of funding needs, resource demands, infrastructure requirements, employment constraints and skills gaps.

The job for policymakers is complicated by dynamic shifts within subsectors and geographies. Some subsectors within a larger industry may be more advanced in adopting low-carbon practices while others may require more targeted support and incentives. There may also be different impacts and requirements across regions depending on local conditions. All of this will require diplomatic skill to cajole a range of stakeholders.

While investors have an important role to play, solving the challenge requires collaboration between financial actors and policymakers. Policymakers must create frameworks and incentives to enable the deployment of capital at scale and speed. As a result, initiatives like COP where policymakers, researchers, and capital allocators meet are crucial in keeping the world on the path towards net-zero emissions.

We expect agreements in renewable energy, green hydrogen, and energy efficiency

Velislava Dimitrova, Climate Solutions and Biodiversity

Given the agenda of COP28 and the news flow around it, we can have a sense of where there are likely to be agreements. Advances in renewable energy capacity and energy efficiency, updates to the Global Biodiversity Framework, and developments in hydrogen and solar power are areas to watch.

COP28 is another opportunity to focus minds on the solutions we need to halt climate change. We have a sense of areas where we can expect agreements to be made, and several of them centre around climate solutions.

There is likely to be a pledge to triple global renewables capacity by 2030. If this is reasonably accompanied by a doubling in the rate of energy efficiency, it would provide a further structural boost for solar and wind companies, and businesses providing energy efficiency solutions such as insulation and smart systems.

As Fidelity International's Anne Richards recently referenced, nature and biodiversity will be on the agenda with potential updates to the Global Biodiversity Framework (GBF), which was agreed at the COP15 Biodiversity summit last year. The GBF is intended to encourage investment in assets that can halt or mitigate biodiversity loss. The UN Environment Programme estimates that meeting international commitments will require US$ 8.8 trillion of cumulative investment in nature-based solutions between now and 2050. But with annual investment at just US$ 146 billion and private capital accounting for just 17% of the total, there is substantial scope for private finance solutions to address biodiversity loss. If this COP can galvanise private capital, it would be a considerable boost for biodiversity-related companies.

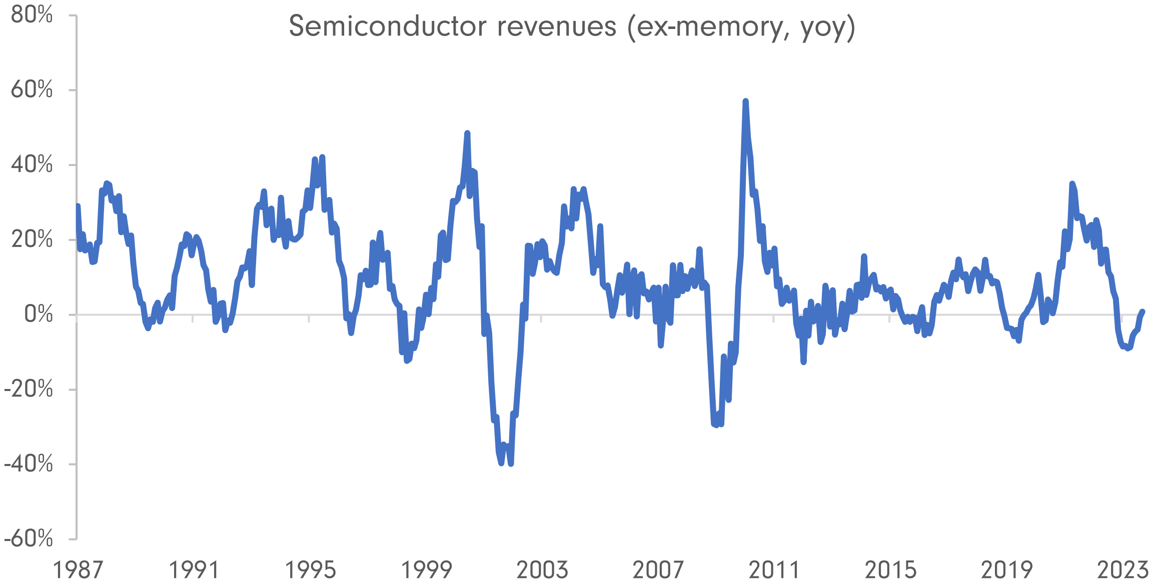
This year has been tough for renewable energy companies and the broader green solutions sector. The market has been concerned about rising interest rates, inflation leading to cost-price timing mismatches, excess capacity, and a lack of clarity on US IRA subsidies eligibility. This has weighed on valuations.

However, regardless of short-term sentiment and the macroeconomic headwinds of higher interests on long duration assets, climate change and nature loss continue to be existential crises. They will remain a priority. As of last year, for every dollar of investment in fossil fuels, 90 cents went to renewables. According to researchers, this ratio needs to be 4-1 in favour of renewables by 2030 for us to be on track for reaching net zero by 2050. There is still huge potential for increasing investment in clean energy.

A key focus of this COP will be hydrogen. Traditional energy companies and those in 'hard to abate' sectors will be looking at the opportunity for renewables, given their use in green hydrogen. In the long term, green hydrogen-driven solar and wind demand is likely to accelerate meaningfully, benefitting companies exposed to renewable energy value chains.

A pledge to double the rates of energy efficiency improvements by 2030 would be a structural driver for building products companies offering efficiency solutions such as building insulation and smart systems. Semiconductor, electronic components, and machinery businesses, which supply technology to enable energy saving in industrial fields, will also benefit. Given we are likely to be at the trough of the semiconductor cycle, and the contribution of many of these companies to greater power efficiency and less energy waste, and their application in areas such as electric vehicles and datacentres, semiconductor names look attractive now.

Semiconductor cycle at trough levels



Source: Fidelity International, company data, November 2023.

The last two years have been challenging for green-enabler portfolios. The outbreak of war in Ukraine, lingering fears of recession, and the impact of higher interest rates on growth stock valuations have hurt green energy sentiment and supported traditional energy prices. But as COP28 highlights, the need for climate solutions has not disappeared. It remains a global priority and many of the proposals under discussion have the potential to lead to meaningful investment flows to solutions providers.

Financing and planning need to be in place for climate adaptation

Shamil Pankhania, Climate Bonds

Climate adaptation is a crucial part of the strategy to combat climate change. While we still need to continue targeting net-zero by 2050, we must also prepare for the inevitable changes in the climate from past emissions. This requires a two-pronged approach of closing the financing gap and developing clear plans to address the impacts of climate change.

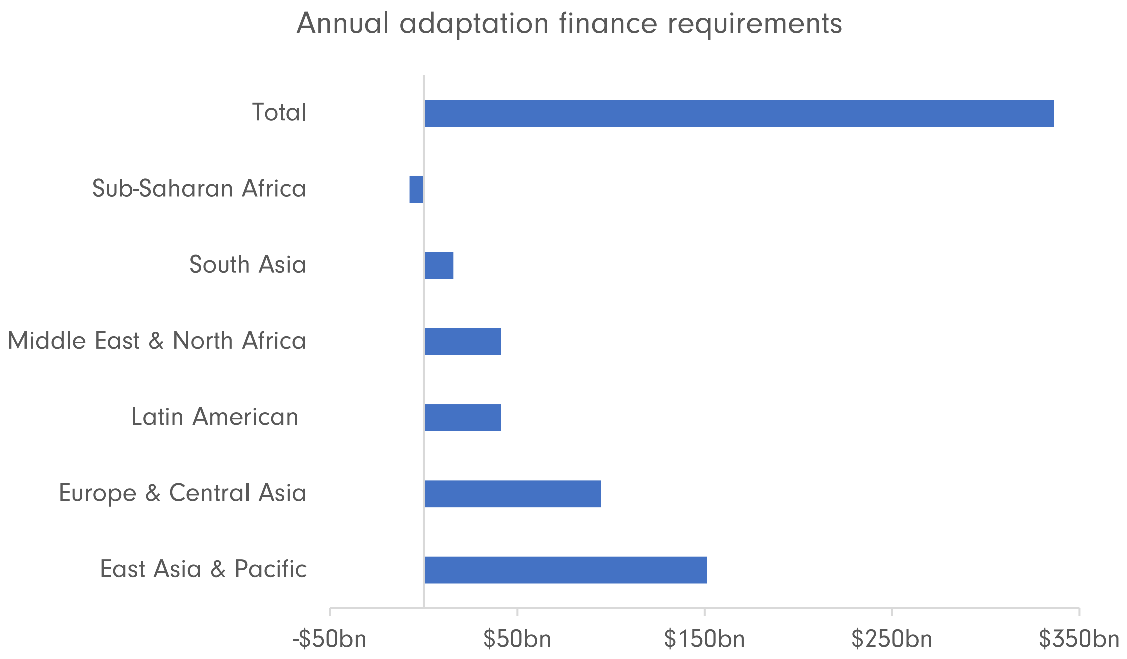
In the US so far this year, there have been 25 confirmed weather disaster events with losses exceeding US$1 billion. This includes 19 severe storms, two floods, one drought, one tropical cyclone, one wildfire, and one winter storm.

Global data shows that natural disasters, which includes weather-related events, are rising over time, and this trend is likely to continue. The Intergovernmental Panel on Climate Change's (IPCC) sixth assessment report published in 2023, warns that the world is on track to experience dangerous levels of climate risk even in a net-zero scenario where temperatures rise by 1.5°C or 2°C. This implies that the impact of climate change will be widespread and severe, affecting vulnerable populations, ecosystems, and economies.

While it will be increasingly challenging to meet net-zero, we must stay committed to it to contain emissions. However, we must also prepare to adapt to a warming world because we have taken too little action so far and the consequences of climate change are accelerating. CO2 emissions from hundreds of years ago continue to contribute to global warming and even if we stopped all emissions today, the world would still get warmer. Climate adaptation allows us to mitigate the potential consequences of climate change and enhance resilience.

The two big problems facing climate adaptation efforts are underfinancing and under-preparation. As the frequency and intensity of extreme weather events increase, it is crucial that we plan for and allocate sufficient capital towards adaptation. Failure to adapt in a timely manner also exacerbates social risks including unemployment, displacement, and migration, due to the physical effects of climate change. This will impact the most vulnerable communities and countries, undermining the efforts of delivering a just transition.

We need to allocate sufficient capital towards adaptation ($USD)



Source: UN Environment Programme - Adaptation Gap Report 2023.

Investors have a key role to play in supporting both the financing and preparation for adaptation. By integrating climate risk assessment into their investment decisions, investors can identify and support companies that are ready for the challenges posed by climate change. This helps protect investments and boosts the overall resilience of the economy. It also presents opportunities. Innovative solutions to the adaptation problem creates a market for sustainable technologies, infrastructure, and services. Investors who can recognise these solutions can generate attractive returns and drive positive environmental outcomes.

We want to see COP28 make concrete progress on addressing the growing adaptation financing gap with policies including international public adaptation finance schemes, domestic spending initiatives, and private sector partnerships. We also want to see better preparation. Fifteen percent of countries have no national adaptation planning body. Moreover, there is no framework for the Global Goal on Adaptation yet, which was committed to at the 2015 Paris Agreement. This framework needs to be robust and include both quantitative and qualitative targets, with particular attention given to the acute issues of food and water systems.

Net-zero cannot be achieved unless the emerging market funding gap is closed

Paul Greer, Emerging Market Debt

Progress is being made in financing the funding gap to address climate change in emerging markets, but it is still far short of what's required and too slow. Policymakers must find ways to close the gap, including developing a robust carbon credits framework and engaging with private finance.

COP28 has got off to a running start with the seeding of a "loss and damage" fund that will help developing countries manage the fallout from climate change related catastrophe. The UAE, UK, US, Germany, Japan and EU pledged over US$ 400 million, following up from COP27's agreement to set up the fund. The hope is that more countries will commit money as the summit progresses.

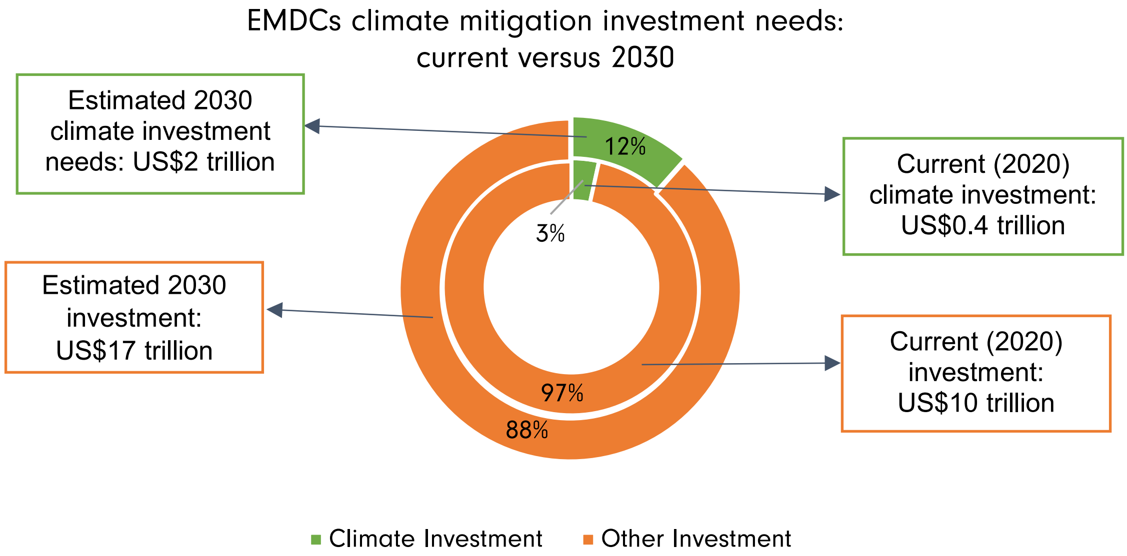
This is good news for emerging markets and developing countries (EMDCs) that arguably face the brunt of climate change effects despite historically having contributed the least to total carbon emissions. However, we must wait to see how effective the fund will be in practice and, given the formidable task ahead of us to offset climate change, efforts must be ongoing.

EMDCs will need to spend more than US$2 trillion per year on climate investment needs, with China responsible for half that figure, to achieve net-zero. EMDCs ex-China need to spend US$1 trillion a year by 2025 and around US$2.4 trillion by 2030. The key areas of spending are transformation of energy systems, accelerating investment in adaptation and resilience, investing in agriculture, and restoring natural capital.

As the COP28 announcement shows, climate finance is increasing, but it is slow, and the funds are mostly concentrated in a few geographies. Countries with weak economies that are exposed to debt-related risks attract fewer international investors, and usually have to finance their climate ambitions through public markets.

East Asia and the Pacific, the US, Canada, and Western Europe alone account for 84% of total climate finance given these regions' abilities to mobilise domestic sources, which are critical to achieving scale. Capital flows continue to fall short of needs, particularly in developing and low-income economies. Less than 3% of the global total (US$ 30 billion) went to the least developed countries (LDCs), while 15% went to developing countries ex-China. The ten countries most affected by climate change between 2000 and 2019 received just US$ 23 billion, less than 2% of total climate finance.

Big shortfall in climate financing for EMDCs



Source: IMF - Global Financial Stability Report, October 2023.

Two areas particularly important for combating climate change are natural capital and energy systems. Both are essential for the economic growth of EMDCs, but without sustainability in mind, this growth would only provide short lived benefits and precipitate climate catastrophe in the long run. Rampant deforestation and reliance on fossil fuels are still major characteristics of developing economies, but there are efforts to reverse these trends, which can be bolstered by additional financial support.

One readily available solution to maintain natural capital, particularly in combatting deforestation, are carbon credits generated from forest sinks, which absorb and store carbon and can work as an incentive to protect and increase forest cover. These carbon credits can be sold to companies as a part of a carbon-trade programme if robust verification procedures for carbon credits are established. The extensive involvement of private finance is also essential. Public capital alone is unable to fill the financing gap, so this and subsequent COP events will need to consider how better to engage private capital.

The world needs a breakthrough and a new roadmap on climate finance that can mobilise the US$1 trillion per year in external finance that will be needed by 2030 for EMDCs other than China.

Strong leadership and renewed net-zero commitments needed at COP28

Julie-Ann Ashcroft, Sustainable Multi-Asset

Sustainable investors are committed to net-zero but need to have confidence in political leadership that has seemed less engaged with climate action over the past few years. It is crucial that policymakers make a prominent display of their commitment to net zero targets, so that long-term investors have the visibility they need to continue to support the energy transition.

At Fidelity, we care about the world that we will leave behind for future generations, which is why we are committed to sustainable investing. But we also have a duty to clients, which is why, for us, investing in the energy transition must be about optimising the long-term growth of assets.

Fortunately, the investment opportunities related to the decarbonisation of our economy are enormous. Rarely, if ever, have we known in advance that such a significant amount of capital would be required in pursuit of a single goal for several decades. Consulting firm McKinsey estimated in 2022 that the net-zero transition would require US$9.2 trillion in capital spending per year on average between now and 2050. Every year, governments, corporates, and consumers are diverting more resources towards reducing carbon-intensive activities, and this will grow over the next decade.

Governments clearly have a primary role in setting the climate agenda. However, it is businesses that will be the driving force behind the development and production of the technology and materials needed to decarbonise our economy. These companies need financing to realise their ambitions, and capital markets are supplying it - there is evidence that greater investor engagement on decarbonisation and climate change is leading to a lower cost of capital and wider access to cheap funding for green energy projects compared to oil and gas.

However, for this to continue, investors need policymakers to set out a clear pathway to net zero and stick to it. Since the outbreak of the Covid pandemic in 2020, a number of global events have drawn attention away from climate action. This means it is even more crucial that the investment community has visibility on climate policy and sees tangible action on past commitments. Reneging on previous goals, changing priorities, and watering down targets sow doubt in the minds of investors, making the allocation of capital to these sectors less likely.

Credible political leadership is essential, which is why COP events are closely watched. Investors have capital to deploy and are enthusiastic partners in the energy transition. If policymakers at COP28 can reaffirm goals and encourage faster action on net-zero targets, it will cultivate the confidence that investors need to make long-term allocations to sustainability projects.

We would particularly like to see a strong message on renewable energy. The sector’s challenges over the past few years due to project delays and inflation-led cost overruns have highlighted that appealing sustainability themes do not always align with earnings and profitability targets.

The renewable energy sector is still attractive, however. Several wind and solar equipment manufacturers are starting to manage their costs and margins better, and given sentiment is still weak, valuations are compelling. If policymakers at COP can offer an unequivocal and united message about their commitment to net-zero, this would provide renewed impetus to the sector and allow companies to make better capital expenditure decisions and instil greater confidence in investors.

Long-term asset growth is our priority and there is a historic opportunity to achieve this by supporting companies at the forefront of enabling the energy transition. A prominent display of purpose, direction, and commitment from policymakers at COP28 is much needed.