24 October 2022

Fidelity Live: Sustainable Investing - COP 27 insights

Investment Professionals

Fidelity International

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There are two weeks until the next UN COP 27 in Egypt. After several commitments were made at COP 26, COP 27 is being billed as the 'implementation COP'. However, the world has changed significantly since last year and it remains to be seen whether gap between climate plans and implementation will be closed.

Today, we are joined by Jenn-Hui Tan, who heads up Fidelity's team of sustainable investing analysts and is responsible for internal and external leadership of our sustainable investing activities. Glenn Anderson, who also joins us, focuses on sustainability innovation and its integration into our investment processes, as well as thematic activities such as the identification of sustainable investing trends. Glenn is also a member of Climate Financial Risk Forum advising the FCA in the UK.

To begin can you comment on what COP 27 is and how it will differ from COP 26?

JHT: The COP is the leading climate conference under the United Nations Framework Convention on Climate Change. It will be held in Egypt this year. COP stands for conference of the parties, parties being the 198 signatory nation states that have ratified the UN Convention on Climate Change (substantially whole world). COP 21 in 2015 was the first time that a global limit of temperature rises to well below 2 degrees Celsius was agreed. COP 26 in Glasgow was also significant, as it saw commitments for US$130tn of private sector capital to be allocated to decarbonisation through the Glasgow Financial Alliance for Net Zero (GFANZ).

What are the key themes you expect to dominate at COP 27?

COP 26 was the 'ambition COP', with countries like China, India, Russia, etc. making strong commitments on climate issues. COP 27 is where these pledges are expected to be brought to life. This might include developments regarding global carbon trading markets, mechanisms to price externalities correctly, the phase out of thermal coal, etc.

We have had eventful 2022 to date, with war and higher inflation impacting on governments' focus on the climate crisis. We have also seen extreme weather events more frequently, such as heatwaves in Egypt and Europe, floods in Pakistan, and droughts in China. Despite all the other events we have seen this year, climate change remains the primary existential risk of our era. The results of COP 27 will likely measure and hopefully strengthen global focus on this issue.

Some other key themes we expect include a likely spotlight on Climate adaptation - to date, focus has primarily been on emissions reduction, but what we are seeing is not enough. We have already experienced 1.3 degrees Celsius of warming and it is very likely that we will exceed the Paris target of 1.5 degrees in the coming decades. As such, people will have to consider how they can adapt to live in this new world, dealing with the loss and damage that will occur. Loss is defined as human-caused climate change losses that cannot be recovered, such as lives, whereas damage refers to things that can be repaired, such as infrastructure.

COP 27 is also being billed as the 'Africa COP' or 'developing market' COP, given the host country of Egypt. Lower income countries being more heavily impacted by climate change, given their geographic locations. It has been estimated that the developing world will suffer US$290-$580bn of loss and damages each year due to climate change, but that the wealthier nations will be better protected. However, the wealthier nations have primarily caused global warming via their historical emissions; as such, countries will be looking for climate justice - with affected developing nations seeking pay-outs from their less-affected, wealthier counterparts, especially if they are expected to decarbonise. Some have estimated that claims could amount to US$1.5tn by the end of this decade.

Glenn, there was a large amount of global attention on COP 26, but it appears there has been less coverage of COP 27 to date. Is this indicative that climate has fallen lower on the world's agenda?

GA: In a word, no - climate is very much still front and centre. Many eyes are on the outcomes of COP 27, as these will set many expectations for the coming years. Recent extreme weather events have brought sense of pragmatism around the need to find solutions that are both practical and scalable. There will likely be a focus on renewable energy deployment and battery solutions, given the increased requirement for energy independence, with solar and wind power likely to be at the core of this for the next 5-10 years.

One dynamic that is expected is that COP 27 will be dominated by headlines created by policymakers pushing initiatives, whereas COP 26 involved many representatives from the private sector alongside policymakers. In other words, we expect to see policymakers laying out expectations for how regulations will be implemented to drive change. As such, COP 27 may create fewer radical headlines than COP 26, as many ambitions have already been raised in the past, but the announcements will be just as if not more important, as they will determine the speed that the decarbonisation transition progresses and the subsequent impacts it will have.

Many people expect the financial sector to be key to preventing climate change, but what specific role do investors have to play?

GA: The key role for investors is in funding the transition. Avoiding the large potential economic losses will justify investment and create opportunity. However, the scale of investment required will likely be much larger than any individual state will be able to finance alone. The global financial system will have to come together to resolve the climate crisis. African countries will be at the forefront, as this is likely where weather events like extreme heat, drought, and water shortages are already most critical. The practical solutions that are found feasible there will need to be scaled globally.

What progress has Fidelity made on since COP 26 last year?

JHT: We made lot of commitments at COP 26 around reaching net zero and deforestation and a lot of our focus this year has been on implementing processes to meet these.

This year, what we are looking for is signals and incentives from policymakers that will allow us to allocate capital efficiently to best promote net zero activities. We need to be able to calibrate our work with policy and the speed of its implementation. A key point is that finance can't deliver net zero by itself, policymakers have to create the environment to push companies to enable it. Policymakers and regulators need to collaborate with the private sector for that to happen.

Our approach is to affect positive change, not to just avoid emissions altogether. We also want to improve value creation as result of our efforts to decarbonise; these kinds of incentive are needed to drive broad global change. For example, we have developed a Climate Rating based on bottom-up research that identifies companies that are genuinely on track to achieve net zero and we are directing capital to these in the expectation that these could face lower regulator risk in the future. We use engagement and influence to push companies to affect positive change and have set minimum standards in relation to our proxy voting behaviour on climate change issues (we will vote against directors where these aren't met).

Another aspect of our activity is that we are running thematic engagements around topics like the phase out of thermal coal in utilities and mining companies, considering dynamics like the 'just transition'. We don't want to simply push those emissions into irresponsible private hands but would rather encourage their winding down over time. Only through such endeavours can we align our strategies with the Paris agreement goals and affect positive change for society.

COP 15 is the Convention on Biological Diversity being held in Montreal in December, what outcomes do you expect to see from that event?

JHT: It is perhaps first important to note how confusing all these different event titles are, but COP 15 is quite different to COP 27, as its focus is on biodiversity rather than climate change. Its aim is to create a global biodiversity framework that can ensure that the world is nature positive by 2030, with a full recovery in biodiversity by 2050. It is effectively seeking to be the Paris Agreement equivalent for biodiversity, as the framework for addressing biodiversity loss is far less developed than that for climate change.

One of the key differences is that biodiversity is location-specific, whereas climate change is a global issue. Therefore, unlike the Paris Agreement there is a need for country-level commitments. However, these will need to consider how developed countries that grew wealthy by destroying their natural resources can contribute to protection and regeneration of biodiversity in developing countries.

Why is biodiversity important from an investment perspective? What is Fidelity doing in terms of biodiversity?

There can be no pathway to net zero without also preserving biodiversity. Marine systems are the world's largest carbon sink, absorbing around 60% of total global carbon emissions. Climate change is also becoming a key driver of biodiversity loss, particularly in tropical regions. Climate change and biodiversity are interlinked, so it is important that they are treated as such.

At Fidelity, we look for minimum standards from companies in areas like deforestation. We use engagement and voting tools to influence companies on such issues. Some of the critical activities regarding deforestation include production of agricultural commodities like beef, soy, timber, and palm oil, so we look at their full value chains, from producers to consumers, to determine the roles of each company. This holistic approach best enables us to affect positive change.

Glenn, going into COP 27 there has been a focus on how the developed nations can help the developing in terms of funding resolutions for such issues. What are your views on this?

GA: This comes back to the subject of climate justice. Many developed nations have grown rich from emissions and using up their natural capital. Developing nations also understand the link between growth and emissions, but everyone needs to work together to break this link. This can be achieved through innovation and investment in low carbon solutions; for example, to help renewables leapfrog fossil fuels as the most economic energy source.

This decoupling phenomenon is something we are starting to observe globally, and we are optimistic that it will continue. As such, we are asking questions like how can technology help improve the economics of renewables, energy storage, low carbon transportation, etc., and how can these solutions be delivered at scale and low cost? The target is straight forward, but we need to determine how to reach it. For financial actors, the key contribution will be funding, while policy and regulation must evolve to drive large-scale uptake of low carbon solutions and facilitate the decarbonisation of existing sectors. For example, targets can be set to try and reduce the use of thermal coal - both public and private capital can work hand in hand to meet such goals - this will require return-risk considerations to become favourable for investors.

How are today's climate, food and energy crises all related?

GA: There is a very strong connection. The ramifications of climate change in encouraging weather patterns like extreme heat and cold events, floods etc. have clear implications for stability in food production systems. As food systems become more unstable and disrupted, total nutritional value will decline, some items will become more expensive. Chocolate may become one such example, given its production has high exposure to geographies facing high levels of climate risk.

The energy connection a bit different. The world's energy system is very resource intensive, requiring international cooperation between producers and consumers. In a world of low carbon solutions, more energy could be produced where it is needed through technologies like solar and wind power. As the world starts to repivot, energy consumers will have opportunities to produce for themselves.

Jenn, how does applying a double materiality lens assist with assessing climate risks?

JHT: 'Financial materiality' refers to ESG factors that can have an impact on the financial performance of a company. 'Double materiality' means examining the impact of such factors on the company, society, and the environment as well. Both are material to the company in different ways, but our view is that over the long term the ways in which companies impact on society and the environment could become investment risk factors. This simply means extending the investment risk time horizon.

Climate is a good example. If your investment horizon is six months, the major risk from climate is some sort of black swan weather event. If you think about the impact that a company has on its environment through carbon emissions over the longer term, you start to think about the longevity and sustainability of a business in a different way. In the longer term, we believe those risks will be reflected in the value; we don't necessarily know how yet, but it could be through regulatory change, such as higher carbon prices, or consumer choice (e.g. the shift towards electric vehicles). The relevant time horizon to consider can be dependent on a wide range of factors - for electric vehicles, it is things like subsidies, cost differences and infrastructure that are determining uptake. Ultimately, we think that looking at double materiality is the right way to undertake long-term investment assessments.

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