

## Carbon 1-2-3

The RBC Global Equity team

### Carbon: We have a problem

CO<sub>2</sub> emissions, greenhouse gases and global warming. These are all contemporary issues that weigh heavily on the minds of asset owners. “How do we construct a portfolio in line with our fiduciary duty to maximise returns while investing in a responsible manner both now and for future generations?” This is a question asked frequently by those mandated with the stewardship of large pools of assets. Usually this question is followed by the acknowledgment that something must be done. What that something actually looks like often is unclear.

This environmental and fiduciary responsibility is compounded by the concept of stranded assets – reserves of coal and oil that owing to environmental pressure, extraction costs and falling commodity prices may prove simply too expensive to exploit. Many energy companies are thus sitting on reserves that although carrying a current value will have to be written down in time. It is essential that companies with significant levels of potentially stranded assets are identified and avoided.

Below we discuss what options fiduciaries have. How can they act to satisfy the needs of the most impassioned of carbon-free advocates whilst ensuring that capital is allocated to companies that will be long-term successes and hence be able to meet future liabilities?

We examine what carbon emissions are, how they are measured and some of the current challenges in accurately pinpointing the true carbon impact of a pool of assets.

Additionally we discuss the options asset owners have with regards to:

- i. divestment – i.e. forbidding investment in those market cohorts that contribute the most carbon emissions to our environment
- ii. engagement – working with companies to produce a long-term sustainable future for our planet

### Measuring carbon

Although we are moving in the right direction, measuring carbon data accurately for a specific company is beset with problems.

The carbon contribution for a company is categorised in to Scopes 1, 2 & 3:

So far so good, however, it gets complicated by two factors:

- i. the incomplete nature of the data and ii) the question of accountability.

<b>Scope 1</b>	Direct emissions over which a company has control e.g. what would come out of a chimney. Utility companies are by far the most intense in this category.
<b>Scope 2</b>	Indirect emissions over which a company has control e.g. electricity purchased from a utility. Heavy industry would be an example of intense scope 2 usage.
<b>Scope 3</b>	Indirect emissions over which a company has direct influence but no control. This would include vehicle usage or employee travel

**Data** – Many developed world companies don’t report carbon data and for those that do much of this is self-reported, unaudited and largely estimated. Few countries (France being an exception) have legislated for mandatory carbon reporting. For the remainder, various data providers attempt to calculate the carbon emissions which, in our analysis, can underestimate emissions by up to 90% or overstate them by more than 200%.

**Coverage** – Only Scopes 1 and 2 are currently included in the coverage which skews a company’s emissions data. Including scope 3 can, in our analysis, change substantially the pattern of carbon emissions given that Scope 3 is anywhere between two to five times the size of Scopes 1 and 2. Indeed some banks may well be amongst the worst carbon performers when scope 3 is included given their financing of energy-intense companies and projects.

**Accountability** – Looking at the various Scopes in isolation tells us little about the overall impact a company’s activities may have. Consider the following two examples: Company A is a highly efficient low-energy producer of incredibly inefficient and polluting trucks. The carbon impact of production under Scope 2 is low. However, under Scope 3 the purchaser of the truck will be assigned the full carbon impact this poor quality vehicle will have on the planet over its lifespan. Conversely Company B, a manufacturer of low-energy lighting, will use comparatively large amounts of energy in the production process however the ultimate net benefit over the life of the light bulb will be manifested in the lower Scope 3 emissions of the end user.

## What to do?

The confusion produced by incomplete data places asset owners in a difficult position. Taking a narrow view of the worst Scope 1 and 2 companies such as energy and utility companies may not capture the full picture. Conversely, a broad approach encompassing all Scopes is impractical from a data coverage perspective at present whilst potentially whittling down the investible universe to an unacceptable level of concentration.

There are two practical options:

<b>Divestment</b>	Exclude industry sectors from investment e.g. all fossil fuel extractors and utilities
	Pros: <ul style="list-style-type: none"> <li>▪ Simple to implement</li> <li>▪ Easily understood and monitored</li> </ul>
	Cons: <ul style="list-style-type: none"> <li>▪ Forfeit ability to influence company</li> <li>▪ Doesn't get to the root of overall energy use across society</li> </ul>
<b>Engagement</b>	Avoid the worst carbon emitters and engage with companies to assess responsible carbon policies
	Pros: <ul style="list-style-type: none"> <li>▪ Influence management to deliver better outcomes</li> <li>▪ Consistent with an integrated ESG approach to portfolio management</li> </ul>
	Cons: <ul style="list-style-type: none"> <li>▪ Time-consuming to conduct individual company analysis</li> <li>▪ May not satisfy the most ardent of carbon activists</li> </ul>

## Next steps

Many asset owners and their advisers now acknowledge that they should be using the power vested in them to achieve better outcomes for our world alongside their fiduciary duty to safeguard returns and deliver outcomes consistent with those anticipated by their members.

Regarding carbon, a divestment approach may offer some initial comfort however it fails to get to the crux of the issue. A passive investor may find it difficult to engage with every company in the index and portfolio construction is left in the hands of a third party. An active portfolio with sector exclusions prohibits engagement with the very segment of the market that most needs a discourse on carbon impact.

An ability to identify a small cohort of well-run companies across all industry sectors, which are committed to a lower carbon world and are acting accordingly, could offer an attractive alternative. Capital flowing to these companies would enable them to grow their businesses sustainably. Those companies that fall short on carbon-related disclosure or are excessive carbon emitters may find a powerful motive to improve when investors move to sell their stock.

It is the responsibility of the asset manager to work with strong companies to lead the way and continue to engage with the improving ones to deliver a lower carbon world that is responsible, desirable and more than likely inevitable.

## ABOUT THE AUTHORS

### The RBC Global Equity team

#### RBC Global Asset Management (UK) Limited

The London-based team actively manages a high-conviction, research-driven Global Equity Strategy. The strategy is strengthened and differentiated by an experienced team of industry experts, a clear investment philosophy and a robust and proven investment process. This process integrates environmental, social and corporate governance (ESG) analysis as well as risk management. Our purpose is to make a positive difference to clients, to the companies we own, and society as a whole through responsible long-term investment.

---

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction. This document is not available for distribution to people in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Global Asset Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the above-listed entities in their respective jurisdictions. Additional information about RBC GAM may be found at [www.rbcgam.com](http://www.rbcgam.com).

This document is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. RBC GAM takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when printed. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of the information.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

® / TM Trademark(s) of Royal Bank of Canada. Used under licence.

© RBC Global Asset Management Inc., 2020

Publication date: (November, 2017)

GUK/20/054/FEB22/A

