RBC Global Asset Management

Carbon 1-2-3

The RBC Global Equity team

Carbon: We have a problem

CO_2 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.

Scope 1	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.
Scope 2	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.
Scope 3	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:

Divestment	Exclude industry sectors from investment e.g. all fossil fuel extractors and utilities
	Pros: ▪ Simple to implement ▪ Easily understood and monitored
	Cons: ▪ Forfeit ability to influence company ▪ Doesn't get to the root of overall energy use across society

Engagement	Avoid the worst carbon emitters and engage with companies to assess responsible carbon policies
	Pros: ▪ Influence management to deliver better outcomes ▪ Consistent with an integrated ESG approach to portfolio management
	Cons: ▪ Time-consuming to conduct individual company analysis ▪ May not satisfy the most ardent of carbon activists

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

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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.

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