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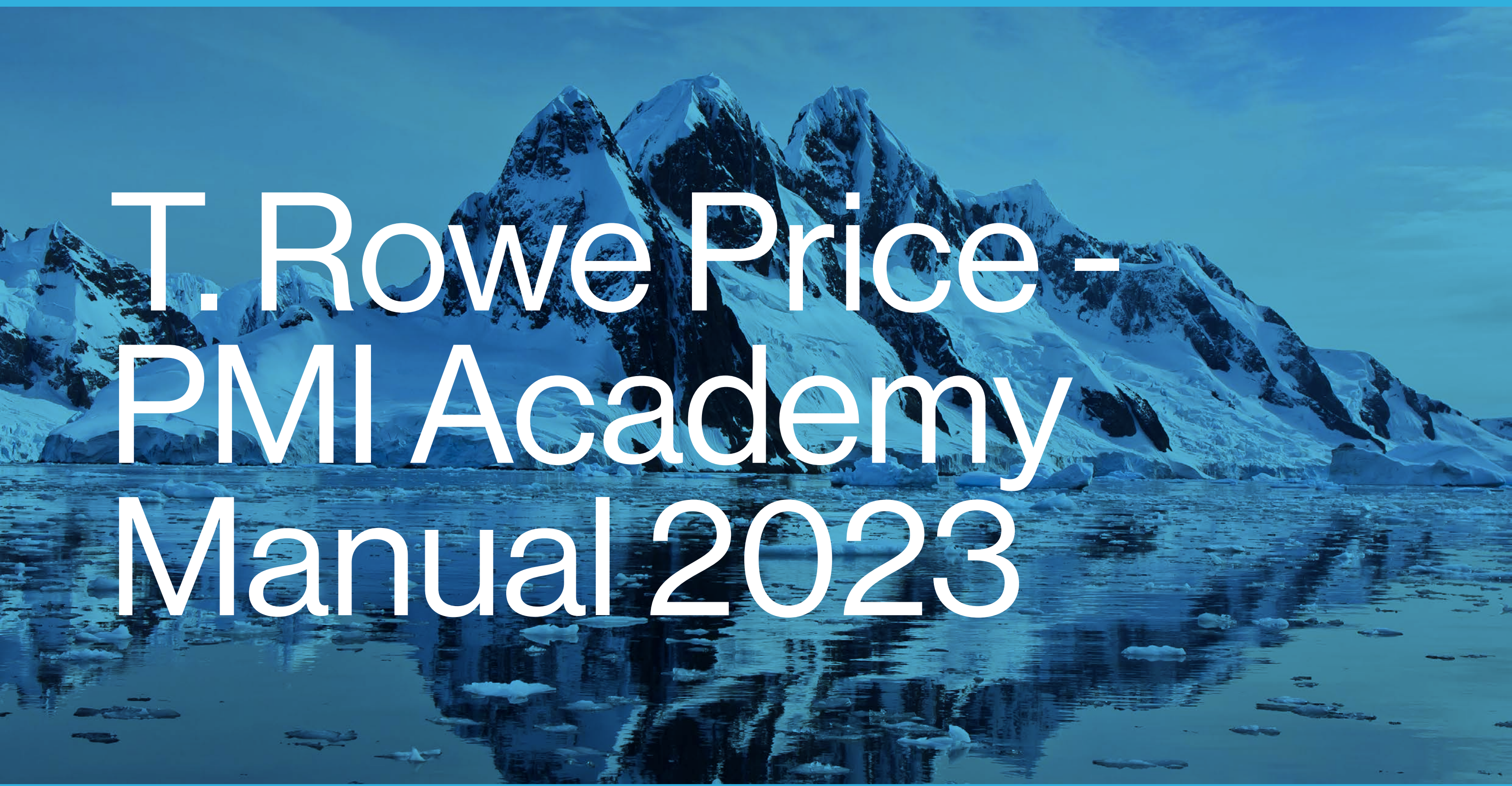

T. Rowe Price - PMI Academy Manual 2023

Divest or engage to meet climate commitments?

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Introduction

Climate change poses a significant risk to the global economy and the stability of financial markets. We can help our clients navigate the transition to net zero by conducting robust analysis on the climate-related factors impacting the companies and other issuers in which we invest and offer net zero solutions.

What is Net Zero?

Net Zero targets the reduction of total greenhouse gas (GHG) emissions to a point where any emissions produced are balanced by emissions removed. We are committed to supporting the goals of the Paris Agreement to hold global temperature increases to 1.5C above pre-industrial levels and achieving net zero by 2050 or sooner.

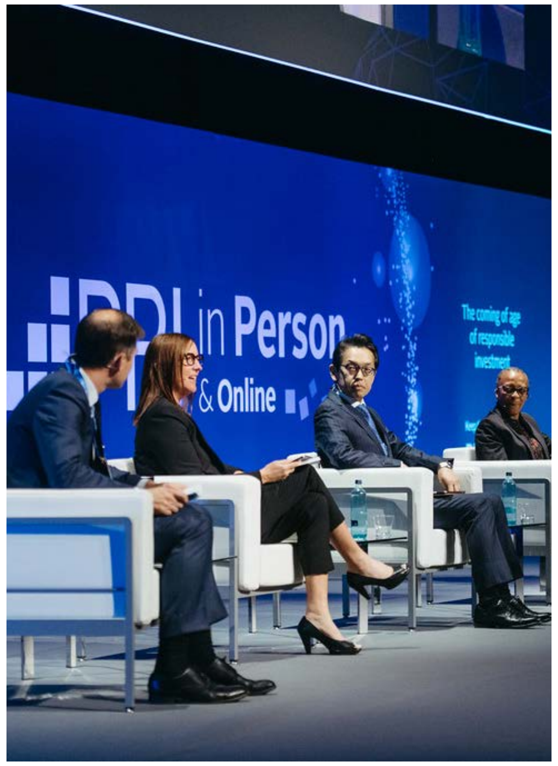
Divest or engage to meet climate commitments?

Maria Elena Drew,
Director of Research,
Responsible Investing, T. Rowe Price

This commits the managers to support the goal of net zero greenhouse gas emissions (GHG) by 2050 or sooner, in line with global efforts to limit warming to 1.5°C. 71 asset owners controlling more than US$10trn have signed up to a similar initiative[1]. While indiscriminate divestments from fossil fuel assets could appear for some as the easy way to reach carbonisation targets, fears of Europe-wide power cuts and industry shutdowns as a result of sharp rises in energy costs have caused some investors to re-consider. For example, the Dutch Title Transfer Facility, Europe's main gas benchmark, hit a record €346/MWh in August, up more than 1200 percent in fifteen months, as buyers rushed to fill storage capacity ahead of the winter. Meanwhile, coal-fired power generation has made a comeback across the European Union, according to data from S&P Global[2].

These realities have led to a rethink of some of the cruder approaches to climate change investing. According to former Bank of England governor Mark Carney, speaking at the COP 27 conference in November 2022[3], crises in finance, health, food, energy, and geopolitics mean "the world cannot divest itself to net zero". How do we therefore reconcile net zero goals with the near-term imperatives to support many households impacted by the surge in the cost of living? Does the long-term objective of cutting all portfolio exposure to fossil fuel companies still make sense?

Divestment as a tool



Panellists at the world's leading responsible investment conference, PRI in Person & Online, held in Barcelona from 30 November to 2 December 2022, focused on just this thorny issue.

According to Maria Elena Drew, Director of Research, Responsible Investing at T. Rowe Price, divestment from carbon-intensive activities and enterprises should be an option for every investor, but it's one that should be used with discretion.

"As a policy, divestment should be in everybody's toolbox," Drew told conference attendees.

"However, I've got some caveats," she added.

"At T. Rowe Price we're predominantly active managers and more than 95 percent of our assets are in active funds. For us, divestment is not as important a tool as it would be for a passive manager."

While a passive manager has to hold every stock in the index it's tracking and eliminating fossil fuel companies from the index is the only way to ensure zero exposure to them, active managers have much greater flexibility, Drew said.

"At the start of our process, we're carefully selecting what is going to go into the portfolio," Drew explained, including meticulously assessing the credibility of their climate change strategic plans and targets as an important component of our normal fundamental analysis.

The need for forward-looking metrics

Too rigid a focus on static carbon footprint metrics can lead an asset manager into difficulties in other ways, Drew went on, citing the utility sector as an example.

"Utilities have an extraordinarily high carbon intensity, defined as emissions over revenue," she said.

"And if you own any utilities, particularly if you're overweight that sector, your portfolio will automatically have a high carbon intensity. However, at the same time, utilities are very much driving the solution to climate change," said Drew.

"When you have that specific carbon reduction objective, you maybe want to couple carbon footprint metrics with forward-looking metrics as well," Drew suggested.

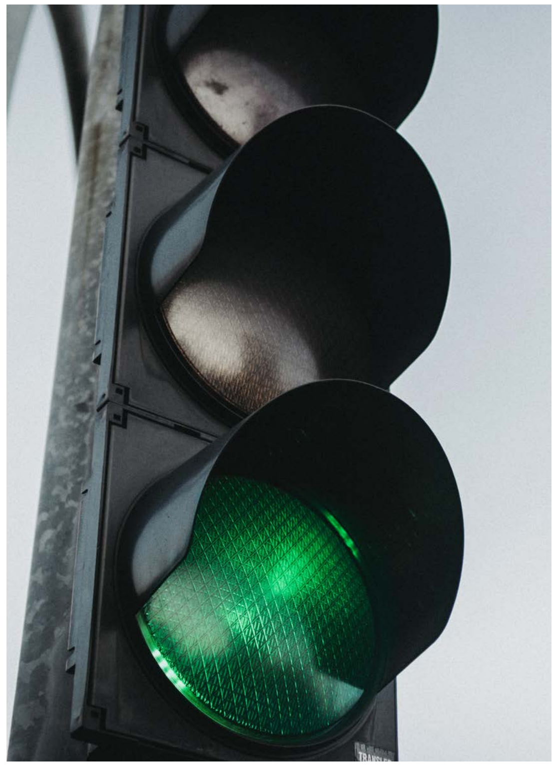
"For example, look at the portfolio's coverage of net zero targets as well as its exposure to climate solutions."

The way in which decarbonisation trajectories are measured also plays a significant role in achieving the right outcome, Drew went on. It's important to combine divestment goals with forward-looking objectives.

"If you think about those carbon reduction targets across a multi-year period, you may be able to achieve your carbon reduction objective without cutting out the financial opportunity and return," she said.

A pure divestment policy may be limited in its practical impact as well: more than half of those responding to a live poll held during the conference session thought that the exclusion of high greenhouse gas producers from investment portfolios would have no effect on real-world carbon emissions.

Engagement goals



If a rigid focus on divestment is unsuitable and eliminating certain companies shouldn't be used as the primary tool to decarbonise portfolios, what approach should asset managers take?

It's engagement with portfolio companies that can play an increasingly vital role in achieving climate change goals, said T. Rowe Price's Director of Research, Responsible Investing.

"We obviously believe that company engagements should focus on decarbonisation when the physical and transition risks associated with climate changed are elevated," Drew told conference attendees.

"We think that there's going to be very strong alignment between companies that are leaders in decarbonisation and financial performance," she went on.

But does engagement always mean shareholders should suggest to companies that they sell or shut down carbon-intensive assets? The discussion can be nuanced, Drew said, citing two examples.

Engagement goals (cont)

“If a company with a tiny sliver of thermal coal exposure decides to get rid of it because asset managers won’t otherwise invest in the company’s stock, is that the right option? When you spin the coal exposure out or divest it, that’s a new stream of capital going into that particular asset. Drew gave the example of mining company BHP which ultimately decided against divesting from their thermal coal assets in Australia.

“Or Shell, for example, has had an asset since the 1960s in the Nigerian Delta, where locals tap the pipelines to pull the oil out. This has caused pollution on a significant scale. Shell could probably sell the asset. But would that the right thing to do? The best case scenario would be for those pipelines to be properly maintained and supervised to avoid leakages, Drew said.

Given the complexities of such decisions, it’s important to monitor and track engagements, said Drew.

“At T. Rowe Price all of our engagements get written up and published on our research platform,” she said.

“Every analyst and portfolio manager knows exactly what we engaged on, what our outstanding asks are of that company and the outcome of the engagement. For any ‘next steps’ that we specify, we will add a specific time horizon,” Drew said.

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Active managers best equipped

Active managers’ ability to use stewardship activities to guide investee companies on their transition paths was confirmed by a poll conducted at the end of the session.

Over half the respondents said that actively managed public equity and debt funds were most suitable for achieving GHG reductions in high-emitting portfolio companies.

Around a third of respondents rated private equity and debt funds as well-positioned, with only 3 percent responding that passive funds could fulfil this role.

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[1] www.unepfi.org/net-zero-alliance/

[2] www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/path-to-net-zero-eu-utilities-keep-focus-on-climate-goals-ascoal-rebounds-72752724

[3] assets.bbhub.io/company/sites/63/2022/11/COP27-Finance-Day-Opening-Keynote.pdf

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