PRI Principles for Responsible Investment

Energy Transition – a global investor perspective

Martin Skancke, Chair, PRI
IFSWF, 1st March, 2017

UNEP FINANCE INITIATIVE | United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

ABOUT PRI

The UN-supported Principles for Responsible Investment

AT A GLANCE

Launched in April 2006 at the NYSE, the Principles for Responsible Investment has:

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UN PARTNERS:

UNEP FINANCE INITIATIVE
UN GLOBAL COMPACT

1650+

SIGNATORIES:

ASSET OWNERS, INVESTMENT MANAGERS AND SERVICE PROVIDERS

63+

US$ TRILLION:

ASSETS UNDER MANAGEMENT

6

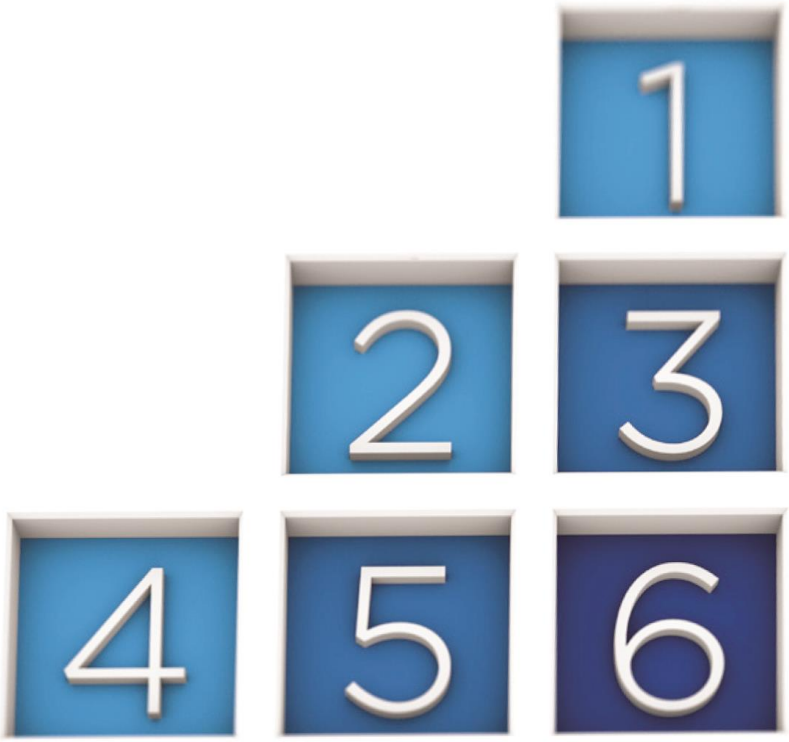
PRINCIPLES:

RECOGNISING THE MATERIALITY OF ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE ISSUES

THE SIX PRINCIPLES

All PRI signatories agree to implement the principles

1. We will **incorporate ESG issues** into investment analysis and decision-making processes.
2. We will **be active owners** and incorporate ESG issues into our ownership policies and practices.
3. We will **seek appropriate disclosure** on ESG issues by the entities in which we invest.
4. We will **promote acceptance and implementation** of the Principles within the investment industry.
5. We will **work together** to enhance our effectiveness in implementing the Principles.
6. We will each **report** on our activities and progress towards implementing the Principles.



WE ARE INVESTOR-LED

MANAGE RISKS, ENHANCE RETURNS, BETTER FULFIL FIDUCIARY DUTY

PERFORMANCE

NOT PHILANTHROPY

"The **high-sustainability companies dramatically outperformed** the low-sustainability ones in terms of both stock market and accounting measures."

Harvard Business School

RISK MANAGEMENT

NOT BREACH OF FIDUCIARY DUTY

"The links between ESG factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is **clearly permissible and is arguably required** in all jurisdictions."

Freshfields Bruckhaus Deringer

RETURNS

NOT SACRIFICE

"There are **statistically significant positive abnormal returns** associated with going long good corporate governance firms and shorting those with poor governance."

Yale School of Management

DIVERSE APPROACHES

NOT JUST EXCLUDING UNETHICAL INVESTMENTS

"We believe that ESG analysis should be **built into the investment processes of every serious investor** and into the corporate strategy of every company that cares about shareholder value."

Deutsche Bank

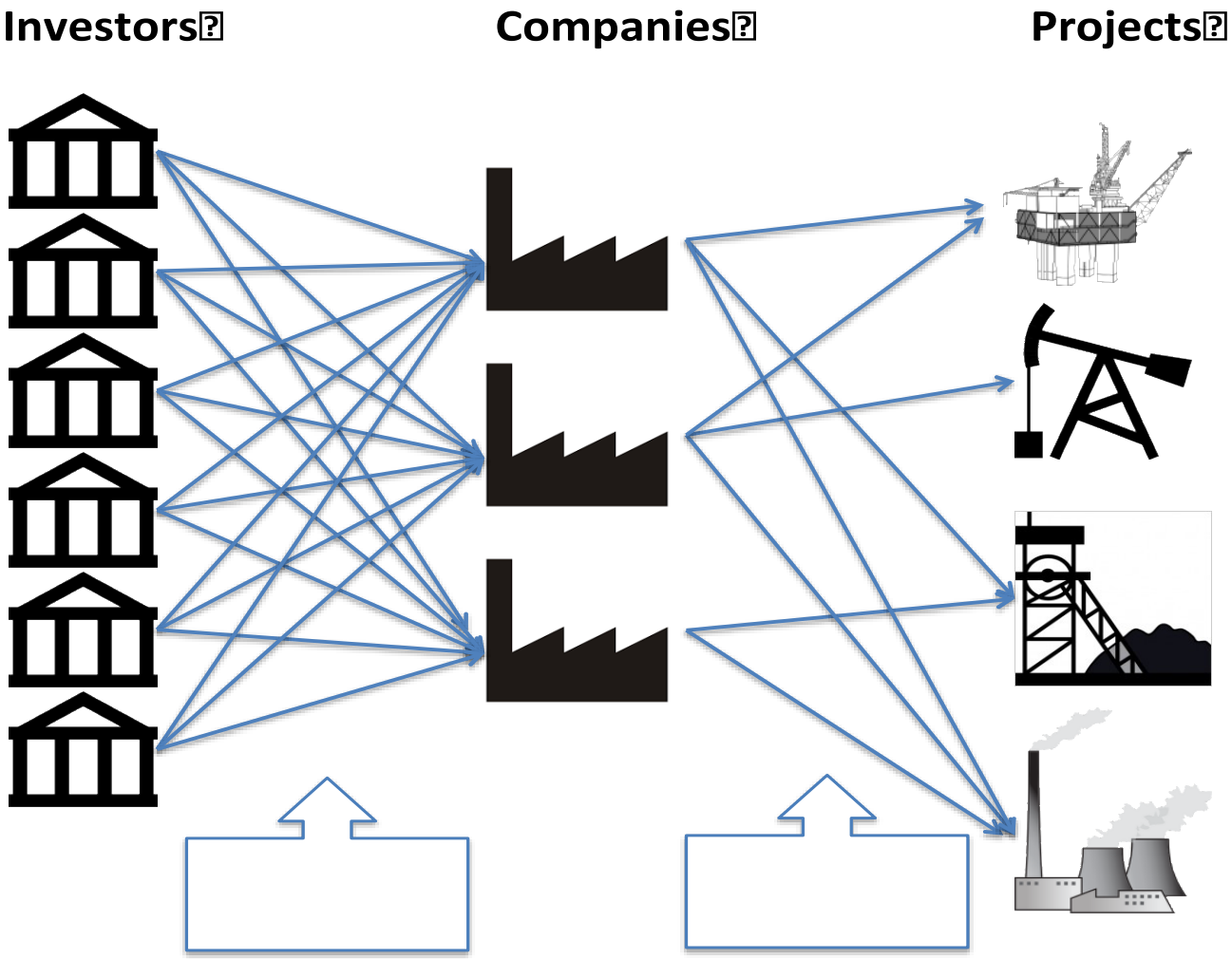
ENERGY TRANSITION

THE RELEVANCE OF ENERGY TRANSITION TO INVESTORS

The transition to a low carbon energy system is relevant to investors for four main reasons:

- Transformation of the energy system will be disruptive, providing risks and opportunities for investors.
- Lack of pricing of CO_2 is a market failure, potentially locking capital into unsustainable investments, with low or even negative long-term returns.
- Climate policies impact many sectors and large parts of the portfolio.
- Consequences of climate change and policies play out over the long-term: climate change is important for long-term investors.

Stranded assets (I)



Stranded assets (II)

- Extracting and burning all available fossil fuels in the world today is not consistent with meeting climate objectives.
- The lack of a proper price on CO_2 emissions combined with principal-agent problems gives a risk of overinvestments in extraction and use of fossil fuels extraction.
- This “carbon risk” is *created* by the investment decisions of companies that extract and use fossil fuels and *distributed* among the owners of these companies through the financial system.
- Must distinguish between imperfections in the market for greenhouse gas emissions (which are obvious) and possible imperfections in the market for financial assets that are exposed to carbon risk (which are not that obvious) – these are *not* the same.
- The phenomenon of “stranded assets” is not new, and it is not at all clear that financial markets are incapable of pricing this risk properly. Moreover, in current value terms, the loss may be limited due to discount factors reflecting the timing of any stranding and investor risk appetite.

ETHICS AND EXCLUSIONS

Investors need to consider the following concepts:

- Application of ethical norms and standards:
  - A product-based approach
  - A company-based approach
- Evaluation on the outcomes of various actions

ASSET ALLOCATION APPROACHES

Key asset allocation-related questions for investors include:

- *What are the possible effects of climate change and climate policies on investments, and how should investors take account of that in their approach to investing?*
- *What are the possible effects of investor actions on climate?*

A general equilibrium perspective

- The average investor must by definition own the market portfolio.
- Since all assets are held by someone in equilibrium, the prices of all assets must be such that supply equals demand for each asset.
- Any attempt for investors to “decarbonize” their portfolios by divesting from fossil fuel assets must be matched by a corresponding “recarbonization” of other investors’ portfolios.
- Equilibrium prices – and hence expected returns – on these assets must equate supply and demand and thus reflect the compensation for risk that the average investor requires to hold them.
- The sum of all deviations from the market portfolio created by active management decisions must be zero. Hence, the sum of all excess returns must also be zero.
- But there can still be a useful role for active management

ASSET ALLOCATION APPROACHES

Investors can consider these key approaches to inform asset allocation

- Active management
- Alternative indices
- Risk management tools
- Divestment as an instrument to achieve change
- Impact investing

ENGAGEMENT STRATEGIES

Engagement should be a central part of an investor approach towards climate change

- Engagement – a key tool to address principal-agent problems
- Engagement can work, but will not work everywhere
- Engagement tools vary by jurisdiction but include formal shareholder rights
- Engagement issues may include:
  - Transparency and robustness of business models
  - Capital structure and dividends policy
  - Transition strategies

APPLICATIONS TO A SOVEREIGN WEALTH FUND CONTEXT

Climate change is an important topic for sovereign wealth funds to consider

- Long-term value: climate change is important for long-term investors, with growing societal expectations of investor action.
- Risk: climate change and policies will impact many sectors and holdings.
- Opportunities: transition presents new investment opportunities.
- Engagement strategies should form a central part of an investor response.
- Capacity: practical tools and investment strategies are already available.

FSB TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

The Task Force's new global framework for climate reporting will bring uniform company disclosures, enabling investors to make better-informed decisions

- FSB Task Force: 30+ industry members
- Draft recommendations published in 2016, final report due by July 2017
  - Focus: disclosure of assessment and management of climate-related risks and opportunities
  - Recommendations: cover governance, strategy, risk management, metrics and targets
  - Supplemental guidance: sectors and scenario analysis

Increasing transparency makes markets more efficient, and economies more stable and resilient." - Michael R. Bloomberg, Chair, FSB Task Force, 14th December 2016

PRI RESOURCES

PRI CLIMATE CHANGE FOCUS AREAS

The PRI is focusing on the following areas in 2017-18, with PRI signatories having identified climate change as their number one ESG topic

- Investment practices: investor assessment of climate change-related risks and opportunities including use of disclosures, aligned with FSB Task Force
- Active ownership: investor engagement with companies on emissions, transition, political lobbying, methane, water and deforestation
- Reallocation: infrastructure, Paris Agreement country climate plans, SDGs
- Policymakers: Paris Agreement, G20 Green Finance and disclosure

PRI INVESTOR GUIDES AND TOOLS

- Fixed income investing guide
- Green Equity Investing
- A Guide on Climate Change for Private Equity Investing
- Sustainable Real Estate Investment, Implementing the Paris Agreement
- Asset Owner Climate Change Strategy
- French Energy Transition Law – Global Investor Briefing
- Montreal Carbon Pledge – Novethic review of portfolio carbon fooprinting
- FSB Task Force podcast

PRI SIGNATORY EXAMPLE

- $1, 674.8 billion
- Insurance firm headquartered in France
- 2015: committed to green bonds, coal divestment
- 2016: implementation
  - Tripling green investments to $3 billion, divesting $0.5 billion from coal
  - Published carbon intensity of investments - Montreal Carbon Pledge
  - Rolling out ESG integration practices across all portfolios
  - Africa climate research programme with University of Cape Town
  - Joined Carbon Pricing Leadership Coalition, FSB Task Force

PRI SIGNATORY EXAMPLE

- $300 billion
- Retirement and health security for California state, school and public agency members, largest public pension fund in the USA
- 2015: committed to Montreal Carbon Pledge
- 2016: identified “systemically important carbon emitters:”
  - Assessed 10,000 holdings in 47 countries
  - Identified 100 companies in 20 countries that account for 50% of portfolio emissions
  - Plan to engage companies on emissions and on climate competent boards

Thank you