

# Observations from 'Decarbonise 2016' in Copenhagen

A workshop on aligning institutional portfolios with the 2 degree climate change target

## What were the Decarbonise 2016 workshops?

The Decarbonise 2016 workshops, organized by Responsible Investor, were designed to generate a fruitful discussion amongst institutional investors regarding the environmental, social and financial implications of climate change.

The workshops were held as a roadshow across ten European and North American financial centers during 2016. In this document FTSE Russell presents feedback from the workshop held in Copenhagen on November, 15 2016, which was attended by portfolio managers, analysts, climate change specialists and consultants from local financial institutions.

The framework for the discussion was set out in a [green paper](#) published by Responsible Investor. The green paper set out the policy and macroeconomic backdrop to the investment discussion, as well as highlighting key questions relating to climate change policy and regulation, energy finance, technical standards and portfolio implementation.

## How were the workshops structured?

The workshop participants took an active part in three roundtable discussions, covering the following areas:

- Carbon footprinting, data and analysis;
- Asset allocation and the investment implications of carbon data and regulatory changes;
- Future portfolio transitioning, strategy and engagement.

## Executive summary

This summary of the Copenhagen workshop highlights the trends that emerged from the participants' comments in the three roundtable discussions:

1. How investors are using climate change data and the challenges involved in carbon footprinting;
2. The extent to which carbon data and climate change are currently being reflected in investors' portfolio strategies and how these policy questions impact on fund trustees' fiduciary and risk management responsibilities;
3. The potential future implications of climate change for institutional investment portfolios.

## Roundtable: Carbon footprinting, data and analysis

Participants in the first roundtable discussion made the point that there are still a range of viewpoints on whether and how to incorporate climate change and carbon risk into investment strategies. The view at the table, however was that, whilst there may not be consensus on specific approaches, market participants cannot avoid looking at the risk of climate change and have little alternative but to seek to measure and address that risk as effectively as possible. The broadening acceptance of climate change risk is thus driving the demand for more accurate climate change related data, specifically carbon emissions data.

### The issue of data quality

The workshop participants shared their experiences of obtaining carbon emissions data, normalizing it and analyzing it. The following comments, made during the course of the discussions, provide an illustration of the challenges investors currently face:

"Everybody understands the need to integrate carbon data but there is a big issue with the quality of data available."

"The Carbon Disclosure Project (CDP) database is not sufficient—its voluntary data so there are discrepancies."

In terms of company reporting, "Some organizations do not take into account the full scope of their activities. When reporting voluntarily, sometimes they make mistakes in how they incorporate their Scope 1 (direct) and Scope 2 (indirect) emissions."

"Looking at carbon dioxide (CO<sub>2</sub>) emissions data alone is insufficient. You might have sectors and activities which create CO<sub>2</sub> now, but actually avoid emissions later on, in the form of Scope 3 emissions."

"There's a big question about how data is normalized. Some carbon-free indexes divide companies' CO<sub>2</sub> emissions by their market capitalization to work out which are the worst polluters. But that way a large US oil and gas company can end up as one of the most carbon-free organizations, which is nonsense."

## Proprietary and public data models

According to the workshop participants, aside from a broad concern about data quality there is also considerable duplication and a lack of standardization in investors' carbon footprinting efforts.

All the participants said that they have internal models for measuring carbon emissions, but that they didn't share them publicly and that, broadly speaking, these models remain unintegrated with the investment decision-making processes within their institutions.

These comments speak to the need for industry-wide standards for data disclosure and greater collaboration and information-sharing amongst practitioners as regards integration techniques. FTSE Russell, for example, operates three analytical models that focus on sustainable investing.

The Environmental, Social and Governance (ESG) model focuses on how companies operate and the resulting exposure to and management of environmental, social or governance risks; the CO<sub>2</sub>e model focuses on companies' emissions of greenhouse (CO<sub>2</sub>-equivalent) and exposure to fossil fuel reserves; and the Low Carbon Economy (LCE) model measures what companies manufacture and what percentage of total revenues are derived from activities that contribute to the transition to a low-carbon economy.

### Three FTSE Russell analytical models help investors measure sustainability

The image consists of three vertical panels, each with a different background color and a white text box. The first panel is purple and contains the text 'How do companies operate?' and 'ESG'. The second panel is dark grey and contains the text 'Do companies pollute?' and 'CO<sub>2</sub>e'. The third panel is green and contains the text 'What do companies manufacture?' and 'LCE'. Each panel also includes a detailed question about the company's operations, emissions, or manufacturing.

Model	Question
ESG	To what extent does the company take a proactive approach to long term business exposure from environmental, social and governance factors to its business operations?
CO <sub>2</sub> e	Does the company own hydrocarbon assets or emit pollutants linked to the greenhouse gas effect that, through their release into the environment, represent a risk to the future stability of global climate and eco systems?
LCE	Does the company provide goods, products or services that, through their utility enables society to adapt to, mitigate or remediate the impact of climate change, resource depletion or environmental erosion?

Source: FTSE Russell

## Roundtable: Asset allocation and the investment implications of carbon data and regulatory changes

The discussions on this theme led to one central conclusion: participants in the Copenhagen workshop are still some way away from making a formal link between carbon emissions data or regulatory changes and their asset allocation policies.

While recognizing the potential investment implications of climate change risks and opportunities, several workshop participants also spoke of their fiduciary

responsibilities, such as obligations to meet investment return targets or to provide for pension scheme members' retirements.

According to speakers at the roundtable discussion, there have been some easy-to-justify past cases of divestment from particular industries or companies (such as those with substantial fossil fuel reserves, for example coal, which pose an evident climate change risk). Such asset allocation moves have been assisted by the development of bespoke index benchmarks (such as the FTSE ex Fossil Fuels Index Series, launched in 2014).

But some participants expressed the view that there is still a lack of suitable low-carbon investment solutions and that, in the absence of such solutions, their preferred modus operandi is to engage with companies, rather than to divest from those seen as potentially high-risk in an environment of heightened concerns about climate change.

The conversation moved to a discussion of asset classes. From the perspective of climate change risk, participants said they had been prioritizing their investments in listed securities but there is now a move towards looking at alternative asset classes and unlisted equities to work out how sustainability concerns can better be taken into account.

At the same time, there was a considerable divergence of opinion on the topic of asset allocation in a climate change framework. Some present at the table were divesting from certain sectors and companies on purely ethical grounds, regardless of whether there might be a resulting impact on portfolio performance. Other, return-seeking investors said they were shy of divestment for fear of missing out on potential returns. Still others have portfolios whose carbon intensity is already low, so the possibility of divestment isn't their most pressing concern.

## **Roundtable: Future portfolio transitioning, strategy and engagement**

Most of this session was devoted to ways in which the perception of climate change investing might change. Many roundtable participants expressed the hope that the investment industry could move away from an approach that stresses the exclusion of companies or industries seen as non-compliant or polluting, and towards a more inclusive environment: in other words, to build investment strategies that focus the reallocation of assets to climate change success stories.

In this regard, an encouraging sign of change is the request by some companies for increased climate change regulation, given that a growing volume of institutional assets is likely to seek a home in the equity or debt of companies perceived as providing climate change solutions.

## **Helping investors design greener portfolios**

In order to identify such future climate change success stories, investors require data that help them identify the revenues accruing to non-polluting companies.

FTSE Russell's Green Revenues (LCE) data model measures the proportion of a company's revenue that comes from green products based on a new Low Carbon Economy industrial framework. The model covers 60 green revenue sub-sectors

within 8 sectors: energy generation, energy equipment, energy management, energy efficiency, environmental infrastructure, environmental resources, modal shift and operating shift.

## Low Carbon Economy Industrial Classification System™

<b>LCEG – Energy Generation</b>	<b>LCEQ – Energy Equipment</b>	<b>LCEM – Energy Management</b>	<b>LCEE – Energy Efficiency</b>
01 LCE Bio Fuels	LCE Bio Fuels	LCE Combined Heat/Power	LCE Advanced Materials
02 LCE Clean Fossil Fuels	LCE Clean Fossil Fuels	LCE Controls	LCE Building and Property
03 LCE Geothermal	LCE Geothermal	LCE Fuel Cells	LCE Industrial Processes
04 LCE Hydro	LCE Hydro	LCE Integrated LCEM	LCE Integrated LCEE
05 LCE Integrated LCEG	LCE Integrated LCEG	LCE Logistics and Support	LCE IT Processes
06 LCE Nuclear	LCE Nuclear	LCE Power Storage	LCE Lighting
07 LCE Ocean and Tidal	LCE Ocean and Tidal	LCE Smart Grids	LCE Video Conferencing
08 LCE Solar	LCE Solar		
09 LCE Waste to Energy	LCE Waste to Energy		
10 LCE Wind	LCE Wind		

<b>LCEI – Environmental Infrastructure</b>	<b>LCER – Environmental Resources</b>	<b>LCMS – Modal Shift</b>	<b>LCOS – Operating Shift</b>
01 LCE Carbon Capture & Storage	LCE Agriculture	LCE Aviation	LCE Finance/Investment
02 LCE Desalination	LCE Aquaculture	LCE Integrated LCMS	LCE Integrated LCOS
03 LCE Flood Control & Land Erosion	LCE Integrated LCER	LCE Railways	LCE Retail/Wholesale
04 LCE Integrated LCEI	LCE Mining	LCE Road Vehicles	LCE Property
05 LCE Logistics and Support	LCE Minerals and Metals	LCE Shipping	
06 LCE Pollution Management	LCE Source Water		
07 LCE Recyclable Products	LCE Sustainable Forestry		
08 LCE Recycling Services			
09 LCE Waste Management			
10 LCE Water Management			

FTSE Russell estimates that the global transition to a low carbon economy is already well underway, with a significant proportion of global companies' revenue already tied to environmentally and climate change-friendly activities: an analysis of the FTSE Global Equity Index Series (FTSE GEIS) using the LCE data model, conducted in October 2015, showed that 7.2% (\$2.9 trillion) of the index's value was derived from green revenues. As a proportion of the global equity market, this is comparable to the 8.3% (\$3.7 trillion) of the FTSE GEIS's capitalization represented by the emerging equity markets at the same date.

In early 2017 FTSE Russell calculated that, of the 7,711 companies in FTSE GEIS, more than 1,880, or 24%, already have some exposure to green revenues, and this proportion has been increasing steadily over the last seven years.

New index tools can also help investors redesign their portfolios with climate change considerations and advanced management techniques in mind. 'Smart Sustainability' indexes, such as the FTSE All-World Ex CW Climate Balanced Factor Index, which now underlies the Future World Fund run by Legal & General Investment Management

on behalf of the HSBC Bank UK Pension Scheme, help to combine climate change risk management with equity factor strategies (such as value, low volatility, quality and size) in a single index-based solution.

## **Recognizing the reality of climate change**

The participants in the Decarbonise 2016 Copenhagen workshop included portfolio managers, analysts, climate change specialists and consultants from local financial institutions. Their discussions showed clearly that investors increasingly recognize the reality of climate change, understand the challenge it poses for their fiduciary and risk management responsibilities and are looking for ways to integrate climate change factors into their decision-making processes. Meanwhile, companies are increasingly viewing the transition to a low carbon economy as an opportunity, rather than a compliance burden.

Even though investors still adopt a range of approaches to incorporating climate change and carbon risk consideration into their portfolios, the Copenhagen workshop revealed a clear consensus that better information and a more sophisticated way to model carbon emissions and analyze green revenues are necessary. FTSE Russell's data models, including its Green Revenues (LCE) data model, represent a major step forward in providing the industry with the tools to do this.

## For more information about our indexes, please visit [ftserussell.com](http://ftserussell.com).

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