Climate change risk

POSES HUGE CHALLENGE FOR LONG-TERM INVESTORS *Interview*

An interview with Helga Birgden, Global Business Leader, Responsible Investment and Jillian Reid, Senior Responsible Investment Consultant

Mercer's new *'Investing in a Time of Climate Change — The Sequel'* report forecasts positive returns for infrastructure and sustainability themed investments, but puts coal, oil, gas and electric utilities in the negative by 2030.

Long-term investors face a huge challenge in light of dire warnings on physical damage caused by climate change.

Released in April at the Mercer Global Investment Forum in Sydney, Investing in a *Time of Climate Change — The Sequel*, follows Mercer's June 2015 report and forecasts positive returns for infrastructure and sustainability themed investments if temperatures are curtailed at 2°C by 2030.

Coal, oil and gas and electric utilities are in negative territory for the same scenario over the same timeframe.

The new forecasts, based on scientific, energy, environmental and economic data, show asset returns based on scenarios where global temperatures rise between 2°C and 4°C above pre-industrial levels to 2030, 2050 and 2100.

Mercer's Global Responsible Investment Leader, Helga Birgden, says we need to cap global warming to 2°C or less for investors.

"Our current rate of emissions fueling global warming could put us beyond a temperature that humans have ever experienced within the next 30 years," Birgden says.

The last time the global mean surface temperature was like today was more than 150,000 years ago - prior to human civilization as we know it and the last time CO_2 concentrations were as high as today (over 400 parts per million) was three to four million years ago.

It is currently possible that we could reach 4°C of warming by the end of the century.

"We need to invest in sustainable infrastructure, energy efficiency, pollution control, sustainable agriculture and timber,'' Birgden says.

"The New Climate Economy estimates that we require investments into infrastructure of about $US90 trillion by 2015-2030.

"That's double the value of the current infrastructure stock that we have; currently we're spending about $US3.5 trillion annually on infrastructure that means we have to double the annual spend into infrastructure and, importantly, that needs to be low-carbon and sustainable."

The global warming dilemma has created 1,200 pieces of climate regulation in 164 countries at 2016 and climate litigation has taken place in 25 countries. Recently two Dutch courts ruled to shut down a coal-fired power station next year rather than in five years' time to reduce carbon emissions.

In Australia, a super member has brought a case against their fund because trustees have not included climate change risk as part of their analysis.

As recently as April, the Australian Prudential Regulatory Authority and the Reserve Bank strongly told trustees that they should consider climate change as a financial risk.

Globally, the Task Force on Climate-related Financial Disclosures (TCFD) now represents $US80 trillion of funds under management, and Mercer is a signatory.

Mercer's Senior Responsible Investment Consultant Jillian Reid says, "climate scenario analysis builds on the common investor tool of scenario analysis to prepare for future possibilities, but determining the scenarios to be applied in Mercer's Climate Risk Analyser tool was clearly a critical part of the exercise."

For a 50 per cent chance of limiting global warming to two degrees by 2100 we need to peak emissions next year, Reid says.

"In the next 30 years, we must phase out coal entirely and 50 per cent of new vehicle sales need to be electric. If we do that we will still be experiencing 50cm of average sea level rise, higher daily temperatures and droughts that are lasting four months longer than they currently do,'' she says.

At the moment, the transition to the low-carbon economy is progressing but is still limited with fossil fuels still 80 per cent of the energy mix, limited carbon pricing and a global fleet of six million electric vehicles, which remains a "very small proportion" of all vehicles.

"This is why the Intergovernmental Panel on Climate Change last year, and Swedish child activist Greta Thunberg and living legend David Attenborough, have reminded us we should be working towards a 1.5°C limitation and we only have the next 12 years to prevent irreversible tipping points,'' Reid says.

Mercer's four key findings say physical damages to the planet will be curtailed if temperatures stay below 2°C for investors.

"The 2019 report is more positive on the transition to a low carbon economy,'' Reid says.

"For example a growth portfolio to 2030 with a 2°C outcome is an extra 11 basis points each year over that time but in 4°C you're losing 7 basis points per year. But, if you move that out to 2050, climate change becomes a drag on returns in all scenarios,'' Reid says.

"It's still better under 2°C than 4°C and when you go out to 2100 it is all downhill from there."

She says transition to a low-carbon economy is now expected to be beneficial from a macroeconomic perspective, different to Mercer's 2015 findings.

"We're also suggesting there's an opportunity for a low-carbon transition premium over the next decade with that 11 basis points becoming 29 basis points annually if you increase your exposure to sustainably themed opportunities, the companies providing the solutions, in this example over this time frame,'' Reid says.

Consistent with Mercer's 2015 report, expected impacts become most visible at the industry sector level, not surprisingly, energy and utilities primarily.

"For coal the absolute value is lost in the next 20 years in a two degree scenario,'' she says.

Turning to asset classes, returns vary significantly depending on the scenarios for equities, property and infrastructure, she says.

The 2019 report provides new modelling which shows changes in returns can be "quite sudden" rather than "nice, neat annualised returns".

"Small annual impacts that become bigger cumulative impacts could then become sudden surprises,'' Reid says.

"That is why the stress testing approach that reviews changes in scenario probability, in market awareness, and expected physical damages impacts is going to help our clients prepare for that eventuality.

Investors who are working with Mercer are able to take this work on how to invest in a time of climate change and apply it to specific portfolios, time frames, asset class drivers, risks and opportunities to prioritise different portfolios by industry sector level exposures and benchmark weights. From there, bottom up analysis will determine the winners and losers Reid says.

"Mercer has facilitated a group of global investors that we call FutureMakers who are actively leading on investing for the future. It is such investors that integrate climate change risk within their governance framework, beliefs, policy and processes, voting and engagement. We encourage all investors to use this work to do the same," Birgden concludes.

Helga Birgden

Global Business Leader, Responsible Investment

Helga advises Trustees, Directors and Investment Boards from super funds, Sovereign Wealth Funds, endowments and insurers on responsible investment – environmental, governance and social. She advises on ESG in portfolios and strategy including institutions such as International Finance Corporation, World Bank Group, G20 and Development Banks. Helga was a key contributor to Mercer's first major climate change paper in 2011, and the 2015 Investing in a Time of Climate Change report and the 2019 Sequel.

Jillian Reid

Senior Responsible Investment Consultant

Jillian provides advice on integrating environmental, social and governance factors; sustainability trends; climate change; and stewardship within investment processes. Jillian was the project manager and co-author for Mercer's 2015 Investing in a Time of Climate Change report and the 2019 Sequel

To contact Helga
click here

To contact Jillian
click here

About us

Mercer's Institutional Wealth business ranks among the world's largest investment consultants and delegated solution providers. Our insights and capability are supported by a deep global knowledge base, sophisticated financial modelling, and advanced investment tools, so we understand the scope of your investment needs.

Mercer Global Investment Forums

Mercer's Global Investment Forums bring together institutional investors, investment managers and senior Mercer investment specialists from around the world. The forums have become one of the most anticipated events in the industry.

Responsible Investment

Mercer's Responsible Investment (RI) team advises institutional investors on why and how to adopt sustainable investment approaches. This includes integrating environmental, social & corporate governance (ESG) factors and broader systemic issues, e.g. climate change and sustainable development, along with active ownership (stewardship). In our advice we recognise the impact on long-term risk and return outcomes and client specific reputation considerations for stakeholder alignment.

Click **here** for more Responsible Investment Insights