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GLOBAL ALPHA PARIS-ALIGNED

All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk. Past performance is not a guide to future returns.

The Global Alpha Team recently launched a lower carbon variant of the core model, named Global Alpha Paris-Aligned. This portfolio offers a pathway for clients to align their assets with the objectives of the Paris Agreement.

In this paper, the first of many we hope to share with you, we provide some background to the Paris Accords and outline how we seek to implement its objectives into Global Alpha Paris-Aligned.

UNDERSTANDING THE PARIS AGREEMENT

The Paris Agreement is arguably the most important global treaty of our generation. It is the first to bring about a universal multilateral agreement on climate action. At its heart, the treaty seeks to strengthen the global response to the threat of climate change by holding the increase in global average temperature to well below 2°C above pre-industrial levels and pursue efforts to limit that increase to 1.5°C.

It is important to remember that the Paris Agreement was mainly about agreeing on the temperature goals. Decisions about the exact rules of the game and what position everyone should play were left until later as the arguments would have sunk the agreement. The real breakthrough lay in the significance of all nations agreeing that a) there is such a thing as a 'dangerous' level of climate change and b) every effort should be made to stay beneath it. While the ambition is clear, how we are to get there is much less so.

Since the Paris Agreement was signed in 2015, more work has gone into identifying potential pathways for reducing emissions at speeds consistent with hitting those temperature targets. It has become clear that there is a significant difference between 1.5°C and 2°C, both in terms of the pace of emissions reduction required and in the severity of impact on society and the environment. In 2018, the Intergovernmental Panel on Climate Change (IPCC) issued a special report which included compelling evidence that the world should aim for 1.5°C as the impacts are disproportionately worse at 2°C. For example, the proportion of people exposed to severe heat is 2.6 times greater in a 2°C world than a 1.5°C one, ice-free Arctic summers are up to 10 times more likely, and species loss is 2–3 times worse in a 2°C world.

THE PATH TO 'NET ZERO'

Carbon dioxide (CO_2) is the most important of the greenhouse gasses, accounting for around three quarters of emissions. Since the start of the industrial revolution, the concentration of CO_2 in the atmosphere has risen rapidly and has already caused temperatures to rise by at least 1°C. Because CO_2 can linger in the atmosphere for hundreds of years, there is a delay between our actions and our planet's reactions, meaning that more warming is already locked in. The Paris Agreement effectively requires humanity to think in terms of a 'carbon budget' – the maximum amount of carbon we can emit if we are to remain within the temperature goals. The best estimates are that we can emit about another 420 gigatons of CO_2 and stay under 1.5°C. Given that current annual CO_2 emissions are around 40 gigatons, we need to take urgent action to reduce our global emissions, ultimately reaching 'net zero', where the volume of emissions released into the atmosphere is equal to the volume removed in the same year.

To help provide guidance to policymakers, the UN and IPCC have laid out what a plausible net zero pathway might look like at the global level. The best estimates suggest we need to halve our global emissions by 2030, ultimately reaching net zero by 2050. But it is important to note that these are averages. Not everyone will move at the same pace. The level of reductions will vary by country, by industry, by company, and even by individual. Under the Paris Agreement, all countries must submit their own Nationally Determined Contributions (NDCs), outlining how far they intend to reduce greenhouse gas emissions. Countries will reach peak emissions at different times, and will follow different pathways to emissions reduction, based on what is feasible and equitable. For every country that cannot reach those milestones, others must do so even faster if the overall global target is to be reached.

THE ROLE OF FINANCIAL MARKETS

Financial markets have an important role to play in this transition. We have great capacity to affect change. One of the biggest barriers to a more rapid response to the problem of climate change is human behaviour. When confronted with trade-offs between the present and the future, we almost always overvalue the present at the expense of the future. It is for this reason that Mark Carney, former Governor of the Bank of England, dubbed climate change the “Tragedy of the Horizon”, as its most catastrophic impacts will be felt beyond the traditional horizons of most people. Financial markets can address this issue at the economic level. They can pull forward future considerations by repricing assets that are most at risk. They can then redirect capital from the companies facing the greatest risk to those that are leading the decarbonisation of our economy.

The finance industry also has an important role to play in holding companies to a higher standard of transparency and accountability. We cannot manage what we cannot measure. Shareholders can put pressure on companies to measure and publish information about their climate footprint. This would improve our collective understanding and inform policymakers’ decision making. Armed with this information, shareholders can also hold companies accountable to the pledges made under the Paris Agreement.

Finally, the finance industry can offer alternative investment approaches, ones that align with our society’s need to transition to a zero carbon future. Making these products accessible will make it easier for savers to vote with their savings. This isn’t about offering ‘low carbon’, but an equitable transition pathway towards net-zero emissions. Some high-emission companies are important solution providers and excluding these companies on emissions alone risks advancing a pathway that is inequitable or simply unviable.

OUR TAKE ON PARIS ALIGNMENT

First, Paris-Alignment cannot be reduced to a number. Implementation of the Paris Agreement requires a thoughtful and coordinated economic and social transformation. Reductionist approaches that distil businesses down to a single carbon metric risk losing important context. For example, the rush to divest businesses based on carbon metrics could be counter-productive to decarbonisation efforts, as a large proportion of global emission sources lack economically viable solutions. These industries require investment, not divestment. That some firms pollute more than others is a mostly meaningless observation. An equitable and just transition necessitates looking at companies through a qualitative lens.

Second, being Paris-Aligned means aligning with a long-term objective, not the current state of play. We expect to hold ourselves to account by demonstrating a reduction in portfolio carbon intensity over time. However, we do not hold ourselves to annual reduction targets, as these are inconsistent with our investment horizon. Being Paris-Aligned is not just about managing downside risk. We need to retain the flexibility to deploy capital to businesses that are fostering change, some of whom may be significant emitters.

Finally, we wish to embrace the Paris Agreement’s mantra of the ‘highest possible ambition.’ Merely having a lower carbon exposure than that of the broader market is insufficient. We must ask, and try to answer, the hard questions. We must acknowledge that this is a dynamic and fast-moving area. We must be open minded to evolving our approach to reflect the best available science. The cumulative nature of global emissions means that the 2020s must be the decisive decade of progress and action.

HOW DO WE DO IT?

Global Alpha Paris-Aligned applies a two-stage process to negotiate the pathway to net zero. The first stage is a quantitative screen that strips out companies engaged in both fossil fuel exploration and production as well as service provision to the sector. Appropriate revenue thresholds are used to allow for the inclusion of businesses engaged in a transformational pivot to renewable energy.

The second stage is where we subject our highest emitting holdings to a proprietary qualitative 3-question analysis. We look at the balance between vital and discretionary emissions, the viability of emission reduction pathways and management's appetite to truly embrace the low carbon transition. We use frameworks such as the Financial Stability Board Taskforce on Climate-related Financial Disclosures (TCFD) and the Transition Pathway Initiative (TPI) to assist our process. And various data providers aid the work with scenario analysis. But fundamentally this is a qualitative endeavour, seeking to reach a well-balanced objective view on whether the company in question is part of the problem, or part of the solution.

We look forward to sharing more details on our process with you over the coming months. But for now, a concluding thought. As already mentioned, the 2020s must be the decisive decade of progress and action. The starting gun will likely be fired at the United Nations Climate Change Conference in Glasgow (COP26), this November. While much of the rhetoric will focus on NDCs, there will unquestionably be greater discussion on the need for asset owners to align their funds to a 1.5°C warming scenario. Given this backdrop, Global Alpha Paris-Aligned offers a thoughtful and equitable way for our clients to truly embrace the low carbon transition.

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