GLOBAL STEWARDSHIP: TOWARDS NET ZERO

Alasdair McHugh, product specialist on the Global Stewardship Team, discusses how the necessary journey towards net zero is approached by the Global Stewardship Strategy.

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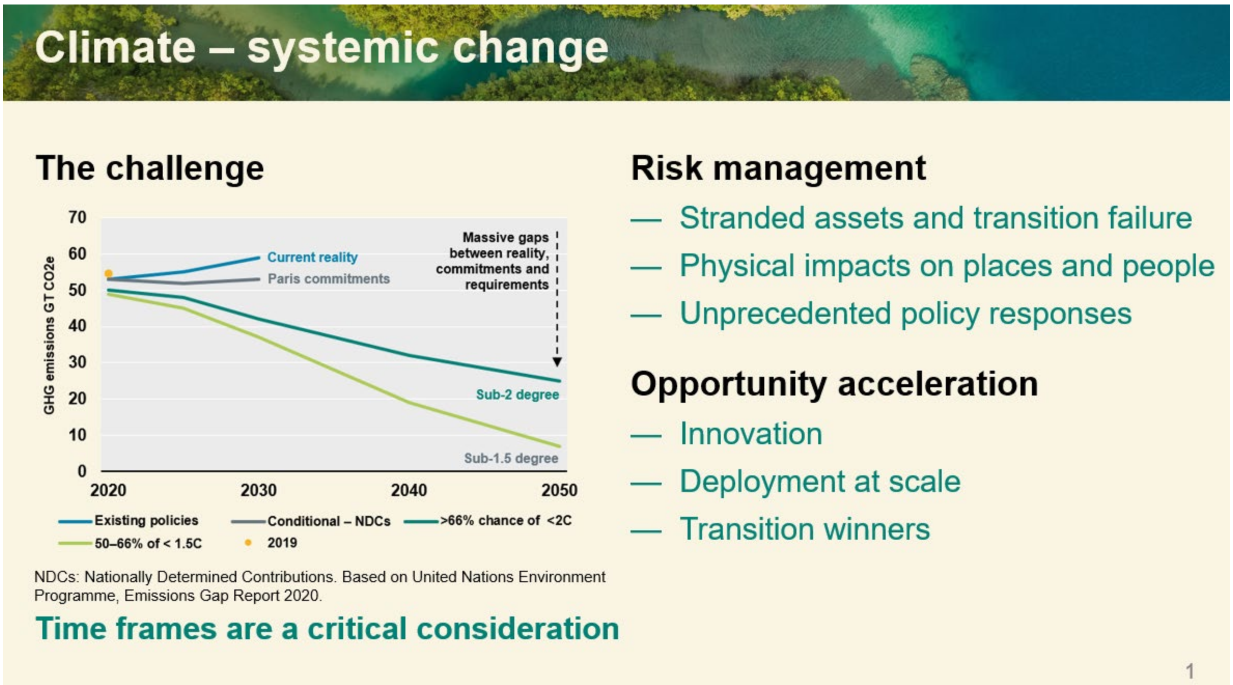
Alasdair McHugh: The energy transition is going to be incredibly complex, but ultimately it comes down to just two numbers: 51bn and zero. At present, we spew 51bn tonnes of greenhouse gases into the atmosphere each year. If we're to avoid the worst effects of the climate crisis, we need to get this down to zero by 2050.

Now that's a massive challenge for humanity. But it is by no means impossible. Properly price, carbon, electrification of transport and probably increased city living are all likely to be part of the solution. Here at Baillie Gifford, we think we have a role to play in the way we manage our Global Stewardship funds, directing capital towards those businesses that are helping the world to thrive.

So where are we at present? Well, let's take a look at some slides.



And the answer, I'm afraid, is not very far. The chart here is constructed from the UN Gap report on global emissions, and it's called this because every annual update shows the gap between where we are and where we need to be.

The little orange dot shows overall emissions of all greenhouse gases, just over 50bn tons a year, with about 43bn of those, carbon dioxide, and the rest mostly methane. The flat line is what countries actually committed to do back in Paris in 2015 to try and at least stabilise emissions this side of 2030. The following lines are the Paris ambition, what we need to do to stay at less than 2° or less than 1.5°. And it's that 1.5° line which is the fabled net zero, or for some, Paris-aligned.

What's happening this year as we run into COP26 here in Scotland is that those 2030 commitments are supposed to be reviewed and increased, shifted closer to the ambition, and we might even get some details of action plans.

Now, climate is a volume game, that's all. If we don't get those volumes down, the temperatures will keep rising. The damage and the physical shocks will keep accelerating. So fixing this could be pretty straightforward. We have or we can see most of the tech we need to live low carbon.

If we just got on and priced that pollutant, there's a pretty good chance that innovation and markets would deliver the transition. But that elegantly simple solution is obviously, actually really hard. The transition will be disruptive and there are so many vested interests in the status quo, which means where we are [is] well behind schedule.

But being more optimistic, we might perhaps finally be about to take off. There is visible alignment now between Europe, China and the US. Europe's raised its 2030 goal to a 55 per cent decline. China has net zero for 2060 in its sights. And Biden's $2tn stimulus came with a fairly large climate bias. And even carbon pricing is now accelerating around the world.

So where does that leave us as investors? Well, I think a quote from a famous British economist named John Kay really sums it up: “We need to manage the risk to enjoy the uncertainty and the opportunities that will come with it”.

We do indeed need to manage the risk, and that means being aware of the actual physical impacts and potential failures to transition. Then we can invest for opportunity. And this is where we're really well placed at Baillie Gifford.

Climate transition is a long-term play. There are going to be some outstanding winners in the new low-carbon life that we build. So our job is to find the real innovators alongside those who will enable us to deploy solutions at scale.

Simply said, but hard to do, and we could talk all day about the complexities, but we try to focus on four steps. And here they are.

Responding to the challenge

Do our homework

Encourage good governance

Support innovation

Engage for capital reallocation

The first is that we do our homework. We don't have to be passive riders in the transition wave. We can think about what low carbon looks like and what will help us get there.

Then it's about good governance. The transition is still at a very early stage. There are many management teams out there who can turn this to their advantage, just as there are many that will unfortunately not fulfil their potential and ultimately fall behind.

Then it's about supporting innovation, looking for those asymmetric growth plays that will bring us new ways of living.

And it's about engaging for capital reallocation of incumbents. There is a real urgency to the climate crisis. We will transition a lot faster if all the skills in the economy are redeployed at pace. A two-way long-term relationship between shareholders and management can really help here. So picking up on a few of those ideas.

A net zero world

Abundant clean energy

Sustainable natural ecosystems

High-quality, energy-efficient buildings

Flexible zero-carbon mobility

Zero-emissions circular goods

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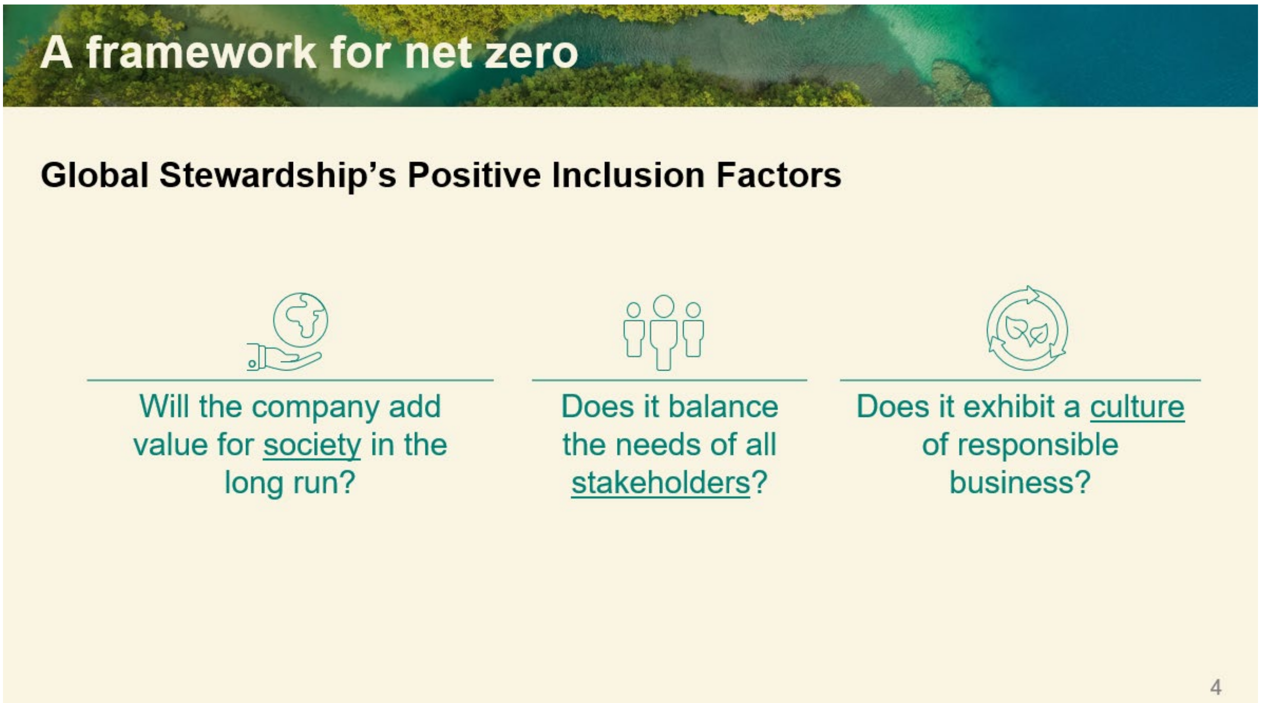
First, what might a net zero world look like? Well, it's low carbon and it's circular. And beneath that, there are probably some things we can be almost certain about.

It's going to be highly electrified. It has to be. That's the renewable energy source that we have. And even more of us will likely live in cities. This can be very resource efficient, but of course, also very challenging to manage.

It's going to be very digital and data driven, and we need to create critical new infrastructure to facilitate that. And yes, it will also be warmer. There is basically no chance now that we'll reverse the warming trend entirely.

So how do we carry that into our investment process? Well, within global stewardship, we have three questions that guide our idea generation and research.



The first is, will the company add value for society in the long run? Simply, are the products supporting the transaction? For some, this will be very material, and for others, it will just be that they work equally well in a low-carbon world.

The second question is, does it balance the needs of all stakeholders? And we know that the environment is too often a silent stakeholder, but it does support all of the others.

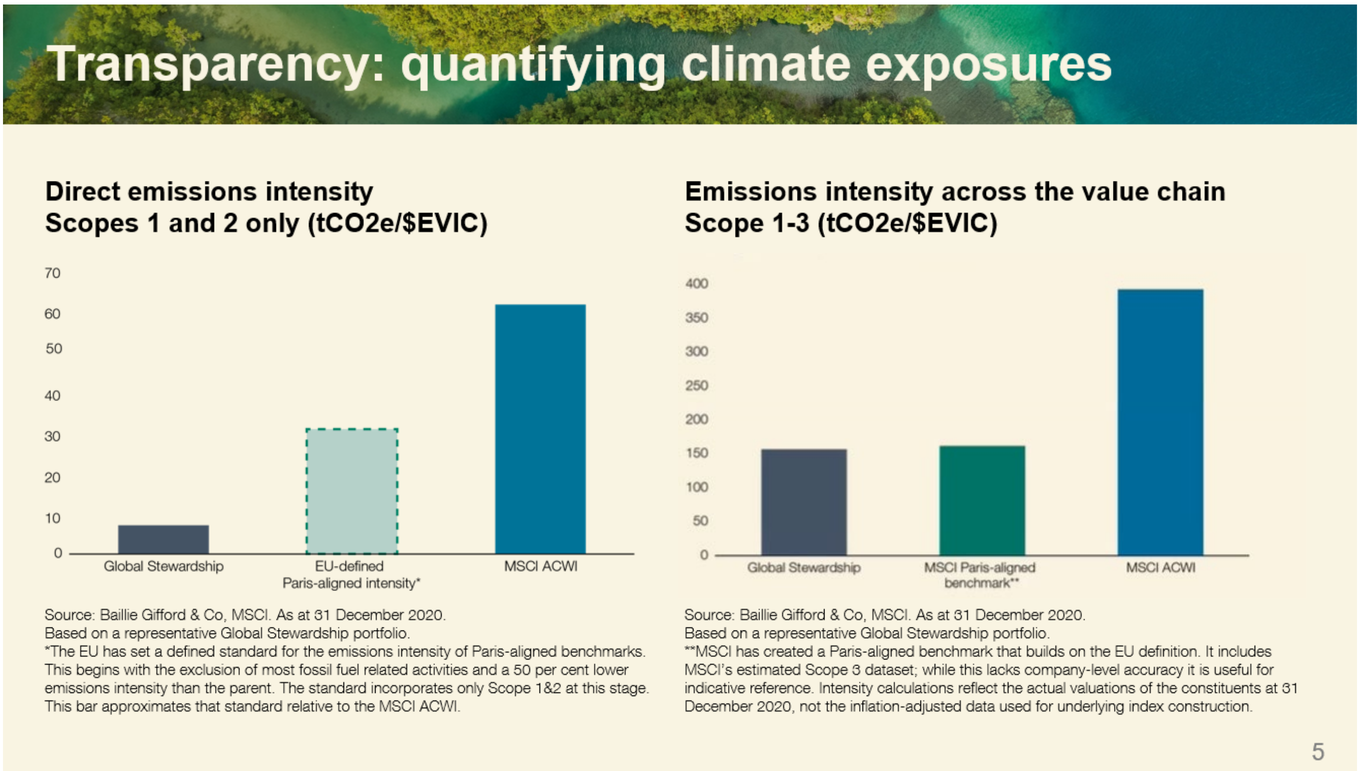
The transition is going to be disruptive. And so a company that takes a holistic view of its place in society is far more likely to be successful. And that speaks as well to the concept of a just transition, a feature that we really need to acknowledge between countries and indeed within them.

And then finally, does it exhibit a culture of responsible business? Now that speaks to good governance, to leadership and to making the most material contribution a company can to the transition. So it's about social networks, promoting facts, not just buying renewable power. It's about amazon enabling us to find out about the carbon footprints of our purchases, as well as just buying those large fleets of electric vans.

And it's biotech companies like Glaukos in our portfolio setting ambitious aims for net zero and bothering to report on managing it's electricity sources.

So with these questions Global Stewardship is not just a climate fund. Following theses positive inclusion factors has given us a climate positive fund we would say.

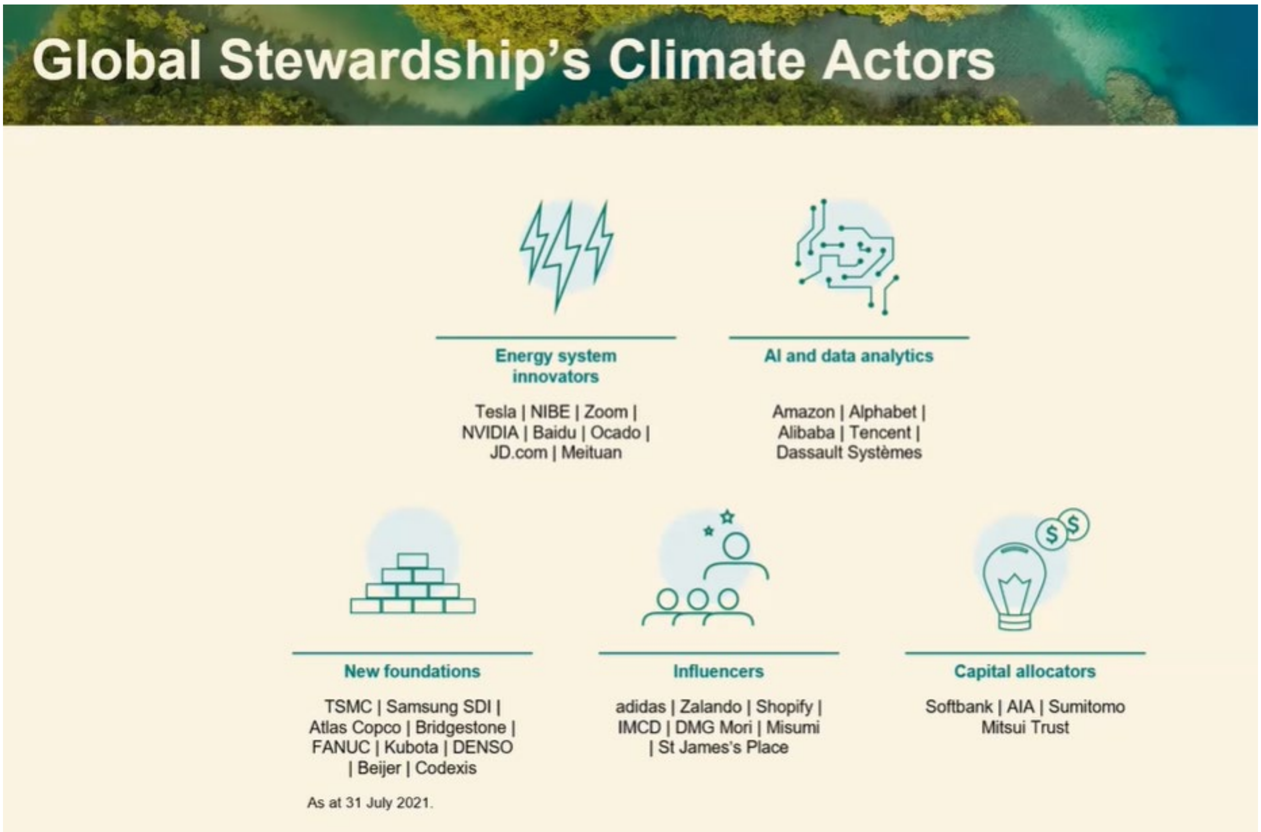
So what does the output of that look like?



Well, on the risk side, we have very low emissions. The chart on the left shows direct emissions, Scopes 1 and 2, our own combustion and power. And we're about 10 per cent of the ACWI benchmark, well below even the indicative EU Paris-aligned benchmark.

And on the right, the graph adds in the Scope 3 emissions, all emissions embedded in a company's products upstream and those caused by the products and services once sold. The data here is very poor I'm afraid so these are estimates but again our exposures look very low versus the economy and in line with the Paris commitments.

But for us, as growth investors, this isn't really the point. Our purposes is allocating capital to solutions, not just removing risks. So I think this slide is much more pertinent to how we think about sustainable growth.



It pulls out some of our climate actors and we need all of these categories to drive a successful and timely transition to net zero.

The innovators like Tesla and Zoom definitely have a place, but we're really optimistic about [what] companies like Ocado or Meituan might be able to do within the food chain or what Baidu or JD.com can do in autonomous driving and logistics.

We also need the scale, what we've called new foundations here. Those companies that will enable deployment, so TSMC and Samsung SDI in semiconductors and battery technologies, but also the likes of Bridgestone that makes tires. We can’t do without tires, so we need them to be made in a way that is cleaner and more circular.

We also need the influencers, companies like Zalando and it's its drive for sustainable clothing or Shopify, which is adding carbon related tools for its merchants.

And then we also need the capital allocators. Both the conventional like SMTH in Japan, but also the mavericks like SoftBank Vision Fund. And tying all this together, we need AI and analytics. The cloud systems of the likes of Amazon Web Services, Alibaba and Tencent are absolutely critical enablers of the transition.

Then, of course, there are own responsibilities. We have a strong set of policies for our own direct emissions, aggressive reduction and verified offsets. But we can't stand still. We need to know more about our portfolio companies. We need to report more and we need to consider more external targets. But, perhaps most importantly, we need to do our bit to support a pro-climate tilt in the playing field that is the economy. So supporting regulators and pro-market policies.

So the climate crisis, I would say, it's the epitome of a complex topic, but it's one that now lies firmly within our investment time horizon. The interim goals laid out in The Paris Agreement are now just nine years away, and that's a relatively short time horizon for a long-term investor.

Therefore this is a real area of focus for us in Global Stewardship. Not just the challenges and the risks that come out of the energy transition, but also the opportunities.

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