

# HEADLAND

## **Has the debate on climate change affected institutional investment behaviour?**

**A report commissioned by The HeadLand Consultancy**

---

**June 2007**

---

## Contents

---

	Page
Executive Summary	3
Introduction	4
Findings	5
Conclusion	10

## Executive Summary

**The HeadLand Consultancy commissioned an independent qualitative study to assess UK asset manager attitudes towards the potential effects of climate change on investment philosophy. 19 mainstream UK fund management houses participated, together representing over £3 trillion of assets under management.**

The potential economic influence of climate change has been recognised by the fund management industry but **has yet to change mainstream investment behaviour**. While corporate governance and SRI policy makers have expressed a fundamental interest for some time, their fund management counterparts see climate change as an influence in the future but not yet core to investment decision-making.

**The Stern Review has stimulated greater interest**, and even those fund managers who have doubts over the science of climate change recognise that the debate will, at some point, have a more pervasive influence.

However, they acknowledge that, as **the impact of climate change is considered to be slow and cumulative, that it was outside a typical fund manager's remit** as "they are not looking at 2012 let alone 2050".

Predictably, **fiduciary duties between pension funds and their managers predominate and climate change is not a central concern within management mandates**. While most respondents understand the role of carbon footprints in business, there was no unanimous view of its level of importance or usefulness in assessing current and future company performance.

**Some scepticism exists over industry's efforts to demonstrate genuine environmental credentials**. Many thought individual company CSR Reports to be of little value, or an attempt to get the "**green fraternity off their backs**".

**There is also an expectation that companies will, in future, deliver more information as well as narrative on the impact of climate change on their business model**. Enhanced Business Plans (under the new Companies Act) could be a useful tool since they should provide an agreed format for greater disclosure and improved communications of business strategies. Standardised KPI's were frowned upon as this could lead to a standardised act of compliance rather than genuine and useful communication. One respondent said: "**companies are unique, so should be their disclosure.**"

**Fund managers are not believed to be re-rating companies in terms of their sensitivity to climate change**, although some acknowledge that this will inevitably happen once disclosure and regulation requirements become more manifest. In principle, fund managers are looking for a light-touch regulatory environment. All felt that the Government must play a central role in providing a stable (legal not voluntary) framework.

## Introduction

### **Has the debate on climate change affected institutional investment behaviour?**

A qualitative survey to assess institutional investor response to climate change, recently commissioned by The HeadLand Consultancy, has identified certain issues in current investment strategy associated with the subject. The research took place in April 2007 amongst a sample of 19 leading asset management houses, representing £3 trillion of Funds Under Management.

Investor reflections on the impact of climate change on their individual investment strategies pose some interesting questions, particularly for Government as it develops its economic and environmental policy to combat the effects of climate change. With the Government adopting a differentiated policy approach, using a portfolio of measures to address the causes and consequences of climate change, (including direct regulation, awareness raising, incentives to change consumer behaviour, application of market forces and fiscal measures), it will be increasingly important for ministers and policy makers to recognise how fund managers view and respond to the emerging scenario. Currently, there exists a less than homogenous view within the UK investment community.

Despite an increase in world-wide recognition of the problems associated with climate change, and its potentially serious economic effects, efforts to create a coherent inter-governmental regulatory framework to achieve reductions in carbon emissions have not yet succeeded in delivering a consensus about the best way forward. This has been illustrated in an increasingly active media interest in the subject over the past 12-18 months which has drawn attention to the risks and consequences of climate change but has highlighted the difficult political and social choices which have to be made in confronting them. While this active political and media debate has been taking place, no public attempt to quantify the economic effects of climate change had generated significant interest until the publication of the Stern Review in October 2006.

As yet, this increase in public awareness and political positioning by Government and Opposition parties has led to little systemic influence on investment strategies adopted by mainstream funds, although it is acknowledged that some alternative fund managers and SRI investors have taken a much more active approach either by investing in environmental plays; or by identifying opportunities for value enhancement related to companies or sectors directly exposed to climate issues.

While climate change is now seen as an issue of general economic concern, it has not yet influenced general investment strategy apart from the sectors covered by the EU Emissions Trading Scheme (EU ETS) and in areas of emerging 'green' technologies. There was, however, a view amongst some respondents that there had been, in the last year, a significant increase in the investment community's interest in climate change and that the UK Government commissioned Stern Review was the trigger for this increase.

## **Findings**

### **Impact of the Stern Review**

The Stern Review, published in October 2006, raised the profile of climate change within financial audiences very considerably. As a result, the topic has moved higher up the agenda within the investment houses canvassed in the research project. Pre-Stern, the interest in environmental matters had mainly been the province of Corporate Governance and SRI teams at fund management houses. To an extent, this has now changed but no clear direction with regards to its influence on mainstream investment philosophy has yet emerged.

### **A disconnect in the investment process**

There remains a clear disconnect between the apparent seriousness of this issue and the actions and attitudes of institutional fund managers. Policy makers within many of the asset management houses are actively involved in establishing in-house terms of reference, and individual SRI funds have been, and are increasingly, a feature of the suite of investment products which are on offer.

However mainstream managers remain more focused on their individual responsibilities which are enshrined in the mandates they receive from pension fund trustees. There is yet little evidence that trustees themselves have given specific instructions on this topic to fund managers responsible for investing fund assets, outside a group of specific investors who have historically adopted a “socially responsible” approach and instructed their managers to invest along directional guidelines.

To the extent that it is forecast that climate change will have a significant economic impact, very little concrete investment action seems to have been initiated, either to take advantage of the opportunities that could emerge, or to discount the counter-balancing investment risks other than to take very general investment influences into consideration,

The research undertaken highlighted that all recognise the on-going debate about the impact of climate change and its importance to the global economy. However, awareness of the debate, and the potential economic consequences associated with the effects of climate change, has yet to drive revisions to fundamental investment strategies.

### **Little evidence of influence on investment trends**

Respondents revealed very little evidence of investment firms incorporating climate change in top-down investment strategies. However, on a case-by-case basis, climate change has stimulated considerable investment activity through the EU ETS. Discussions highlighted one reason for the lack of a top-down approach: as climate change is generally seen as a part of SRI, and it depends on how SRI as a whole is integrated into the house investment style and process. Apart from the firms recognised as leaders in responsible investing, only in three of the respondents' firms did there appear to be a formal system for including SRI in the assessment methodology. One further firm suggested that such a process was under development.

Respondents varied in their thinking that climate change should be viewed as both risk and opportunity. Some immediately cited the number of new business opportunities that have emerged, such as direct investment in carbon traders, alternative energy (solar, wind, hydropower, fuel cells, bio-fuels) and companies specialising in energy monitoring, new energy distribution technologies and energy efficiency improvements.

While some mentioned that they were about to launch new technology or climate change funds to invest in these opportunities, or were including companies with relevant expertise in their portfolios, there was some concern that the number of new companies capitalising on the potential opportunities meant that there was a danger of the new technology market overheating. That a bubble mentality could emerge was the view of some. In this context, there was also concern amongst all the respondents about investment risk from uncertainty arising from the next stage of UK and EU regulation on emissions trading.

### **Influence of public opinion**

Other triggers cited were enhanced media interest in the global causes and consequences of climate change, the political overtures and manoeuvring for the green vote amongst political parties which has emerged, intergovernmental summits, and the recently published Climate Change Bill. Consumer green activism and the marketing strategies employed by retailers such as Marks & Spencer were also mentioned as very important factors in generating and sustaining interest in climate change amongst the investment community. A number of respondents said that even those fund managers who still doubted the science of climate change had to recognise that the weight of public interest demands that it be considered as an investment issue.

### **Where some risk already lies**

The risk that climate change already poses to sectors such as insurance, power generation and transport, where the impacts are relatively clear and direct, has been recognised. However, the impact from broader and less direct implications, and possible changes to regulation and the policy environment (such as the potential expansion of the EU ETS to more sectors after 2012), appear, as yet, to have had little impact on current company ratings and valuations. It seems, therefore, that limited, if any, fundamental in-house investor analysis has yet to take place (amongst the participants) whereby either “winners” or “losers” (associated with this issue) were calibrated and consequent investment decisions taken.

### **In-house policy makers more focused on investment risk**

SRI and corporate governance experts were more focused on the risks associated with some industries. The most frequently sectors mentioned related to the utilities and mining sectors and how they managed emissions trading. This is understandable given that the issue of climate change is perceived by many SRI investors to be one of the more significant risks that companies need to consider.

Emissions trading is one of the few measures being applied where the general and non-quantified risks of climate change are made tangible and have immediate commercial impact. The insurance sector was also cited as likely to be severely affected. Respondents also acknowledged that risk for some would be opportunity

for others. The building industry was noted as one likely to be regulated. But only one fund manager thought there would be opportunities to identify and invest in those companies which anticipated regulation and either took advantage of the opportunities presented; or mitigated the associated risk.

### **Climate a longer-term concern**

Closing the gap between long term portfolio realignment and shorter term climate change opportunism is viewed as a “chicken and egg” situation. Fund Managers take most note of the issue when companies tell them they are factoring climate change assumptions into their own corporate planning. However, most companies have not yet explicitly communicated the implications of climate change on their own businesses for consumption by the market. While some are issuing policy guidelines with regards to their own carbon footprint, there seems generally to be little adoption of the economic opportunities which could arise; or the converse risks that might apply. However, most investors recognise that this will change as the obligation to consider and communicate commercial risk and opportunity becomes more pressing.

At the moment, if companies are not asked questions about the influence of climate change on their business model and strategy by the fund managers they meet, they seem to conclude that it is not an issue of particular concern to investors.

### **Investment mandates – Trustees give little guidance**

Fund managers are bound by the mandates agreed with the trustees of the funds they manage. In the case of pension funds, if the statement of investment principles does not include an obligation to consider climate change, managers have no responsibility to take it into consideration. Respondents suggested that even those companies which have themselves identified and are managing climate change issues in their own businesses may fail to ensure that their pension fund trustees do the same. Some also believe the onus rests on trustees to instruct both corporate management and fund managers to drive changes in corporate behaviour that would, in turn, generate movement towards a more sustainable and low carbon economy.

The fund managers view that their basic fiduciary duty is to maximise returns under the terms of the mandate established with each individual pension fund client. Quarterly reporting to clients, whereby fund and manager performance is assessed, seems to be the over-riding influence. As one respondent characterised it, “it’s all about making money for clients.”

Respondents suggested that “long term” for the investment community under most of these conditions is around three years, with “short term” characterised as adjustments caused by events which occur that affect the strategic outlook. On this basis, climate change (with its scientific projections assessing trends and scenarios on a 50+ year horizon) and in the breadth of its economic and societal impacts, is simply far too long term for institutional investors to take into account when making investment decisions even if they are aware of general sectoral trends.

Despite the fact that pension fund liabilities are also by their nature long term, fund managers' time horizons appear restricted. Only one respondent spoke of including a longer term view in the investment perspective.

### **Government action – and the market response**

Over the past decade, the UK government has identified and begun to enact a number of measures which aim to reduce the risk of climate change by tackling the processes, actions and behaviours which contribute to global warming. The UK is the first country in the world to establish in legislation its goal of becoming a low carbon economy. It pioneered the use of emissions trading for carbon, influencing the creation of the EU scheme and sought to concentrate learning and experience in the UK. Earlier this year, it introduced the draft Climate Change Bill, the goal of which is to “demonstrate the leadership required to encourage others to engage in an international framework to minimise the cost of making the transition to a low carbon economy”. It has also made clear that it will not prescribe the “precise solutions”, but rather create a policy context which gives opportunity for all stakeholders to drive change within a clearly defined framework.

This non-prescriptive approach should present a reasonable (albeit complex) platform for intuitive investors. Some respondents called for further clarity and light-touch regulation, clarity beyond 2012 (which marks the end of Phase 1 of the Kyoto Protocol targets) and on policy development which allows investors to calculate better risk and opportunity, especially of emerging markets. Others preferred market-based solutions, expressing caution about regulation, fearing that it could put UK plc at a disadvantage as companies might regard regulation as burdensome or unnecessarily restrictive. The risk which arises is familiar: one of corporate relocation or investors channelling funds into less heavily regulated markets. Recognition of a need for balance between regulation and market-based solutions was a common view amongst respondents.

Public policy measures have clearly compelled the investment community to take climate change into account in the specific area of emissions trading. Some respondents expected trading to continue to play a major role with the possibility of expanded coverage to include all greenhouse gases and possibly other sectors. Views on how this should be done were varied, from those who wanted the UK to lead by example, and those who were concerned that the UK would lose negotiating traction by being too far ahead of other countries. All agreed, however that the Government needed to make further progress in establishing a stable framework from which companies can plan and investors can assess risk and opportunity.

### **Sources of information**

Respondents did not consider the Government as a direct source of information on either the environmental or economic impact of climate change. Investment managers did not receive information directly from NGOs or environment pressure groups. Rather than from these sources, respondents obtained information from media coverage and acknowledged the impact of high profile and active consumer interest. This was seen as being indicative of the importance of the issue, noting that even those who do not personally believe the science of climate change, admit that it is an issue which merits their attention, given the widespread public response and concern.

**Role of companies**

Several respondents thought individual companies held responsibility for creating greater interest in the causes and consequences of climate change on their businesses and in their sectors. This could be accomplished by companies providing more detailed information on all material non-financial issues, particularly using the new Business Review which requires public reporting against targets and key performance indicators, coupled with forward-looking statements.

There was some consensus about the questionable value of individual company CSR reports. Several respondents voiced scepticism over business efforts to demonstrate their environmental credentials, thinking it often little more than attempting to get the “green fraternity off their backs.”

## Conclusion

Despite the very considerable public debate, and the prospect of more direct action by Government to mitigate the causes and consequences of climate change, there is not yet a cohesive market response to the issue, or a resultant strategic shift in the mainstream investment process. All respondents recognise that it is an issue which will have an influence but, apart from those reflecting a socially responsible theme, no formed strategies emerged whereby fund managers seemed to be actively considering what effects climate change could have on fundamental investment choice/decision-making.

Specialist investment vehicles seemed to be the focus of those asset management houses interested in the subject, although most of these are SRI driven and, therefore, are not run under the auspices of a typical UK equities fund. However, there is some evidence that SRI policy is having an influence on investment strategy within a few of the houses which participated, c20% of whom confirmed that policy considerations could be factored into decision-making.

In terms of a directional change to investment, fund managers are generally tied by the terms of reference agreed with each pension fund client. There is little or no evidence to conclude that these mandates have yet to include guidance on, or requests for managers, to take the influence of potential climate change issues on investment decisions (other than by those clients who have traditionally included environmental and socially responsible guidelines in their investment mandates). In general, most fund trustees' guidance seems to focus on the maximisation of returns, and have not required any analysis of risk and opportunity in terms of climate change influence on portfolio management.

Together with most corporates, investment managers are seeking more clarity on future public policy. Overt dirigisme is a concern, with most fund managers favouring the provision of a policy context which provides the opportunity to drive change without proscriptive legislation, which they believe could lead to damaging consequences.

In conclusion, the research has shown that despite acknowledgment of the growing debate of the impact of climate change, it is still considered an area of specialist interest. It is not yet regarded as relevant to mainstream fund management except in those firms which have established themselves as leaders in the responsible investment field. Investors want greater clarity from the Government and speed in providing a stable framework and, from companies, they want ownership of the climate change issues which impact their businesses and industry.