ESG Now Podcast

"So, About That Climate Transition…"

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Bentley Kaplan
Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode. On today's show, we're going to slip out of the buzzing chaos of New York Climate Week and into a quiet café. To take a look at how investors are approaching the climate transition. Because it has been a few years since companies and governments lay down ambitious and encouraging climate targets. And even if we may be on course to miss some of these targets, in a few sectors at least, the low carbon transition is well and truly underway.

Depending on your investment objectives, this transition will mean different things and different strategies. So we'll take a look at what these different strategies might be, how to think about the potential financial risks and opportunities from a climate transition and why the debate in the world of fixed income is just starting to heat up. Thanks for sticking around. Let's do this.

The last week of September this year is New York Climate Week, an event that's now in its 14th iteration. It's held in conjunction with the UN General Assembly and allows the participation of global leaders and senior government representatives. And some of my favorite colleagues are right there in the thick of it. Talking climate risk, net-zero alignment, opportunities from climate solutions, carbon credits, and everything in between. So as the week described as "Burning Man for Climate Geeks" by the New York Times unfolds, we're going to take a beat. And rather than skittering between panel discussions on the sidewalks of the Big Apple, we're going to settle into a comfy chair and take a little status check on how investors are thinking about a potential transition to a global, low-carbon economy. Something I'm going to call the "climate transition" for short.

We have a little bit of everything in this episode from different investor approaches to the climate transition, to the world of transition-related funds, to ways to think about individual company risks and opportunities and some re-emerging debate in the world of fixed income. But first up, and to help me set the stage, I called up Meggin Eastman out of MSCI's London office.

And Meggin really is the perfect guest to tackle such a broad topic, and that's because she's constantly working with a range of stakeholders in the financial sector, but also because she can take a whole lot of jargon and distill it down into something clear and incisive. And then I get to take credit for it. And what I asked Meggin to do was to outline the different types of investors that might be thinking about the climate transition and how that may impact their investment approach.

Meggin Eastman

A lot of the conversations about transition seem to focus these days, especially in Europe where I sit, seem to focus around transition finance, making the transition happen faster or better, but that discussion actually loses sight maybe of some of the wider considerations that investors have all over the world. If I were to break it down, I would think that driving the transition, devoting capital to make the transition happen on a faster or better basis is one piece of it. But then there's this whole other piece that you can kind of break down into different parts, I suppose. But it's really about the financial implications of the transition.

So if your thesis or belief as an investor is that it is happening or it will happen, then that implies a lot of changes in the economy. Even if as an investor you don't feel like it's your place or you're under constraints so that you can't really drive it, you still need to be taking it into account, both from a risk perspective for sure. As the economy changes, there are going to be winners and losers, there are going to be regulatory changes and so on, and those could have significant value for portfolio holdings. But there's also the opportunity side of it, which is massive because like I said, winners and losers. Winners is part of that.

And so you want to make sure that you have a pretty good view of how your holdings are positioned and where those opportunities or possible pitfalls might be so that you can think about it year-on-year, decade on decade. And then maybe the final category. So we think drive the transition, pay attention to the financial implications of the transition. And then there's this sort of third category, which I think of as alignment. It's a little bit muddled because I think it does actually incorporate both elements of the other two. But because there are explicit commitments out there, lots of companies, lots of investors have said, "We're going to be net-zero by 2050," or "We're decarbonizing," or "We want to be aligned to a 1.5 degree scenario or a two degree scenario."

And so this idea of aligning your portfolio so that it's, let's call it transition compatible, is something that you also see a lot. And that tends to involve both a bit of avoiding things that are not aligned. So maybe that's a heavy fossil fuel, that kind of thing. Maybe seeking out things that are not just aligned but are actually going to benefit and that will enable the transition. And then there's this whole sort of fuzzy middle where it's companies that are neither going to be put out of business by the transition, or that are going to drive it with their business, but that need to adapt. And so that looking at alignment, there are those companies on a path to be compatible with the transition as it happens.

Bentley Kaplan

That's pretty short and sweet. Some investors are looking to actively support and accelerate a climate transition, some want to navigate specific risks and opportunities that emerge from that transition, while others are looking to align portfolios within specific transition related guardrails. But the investment world is not necessarily structured into these neat categories. To illustrate that and in a neat piece of research, my colleagues, Rumi, Xinxin and Shuang took a look at the state of climate transition funds. There are some encouraging takeaways here in that the allocations to these climate transition funds have been growing.

And they are by and large generating positive returns relative to a benchmark or parent index. But quite tellingly, all active funds had their own interpretation of transition, but some funds also targeting social considerations. And in a relatively new climate transition space, this just underscores the importance of understanding different investor categories and what specific objectives are guiding strategies. And we could really dive into each of these different investor categories and flesh out some details. I could nod sagely as I trooped in guest after guest, but I know that your time is precious.

So I'm going to take Meggin's three investor categories and pick the one that maybe seems the most straightforward, but actually has a rich well of data and questions. And that is the investors that are looking to figure out specific risks and opportunities that might emerge from a low carbon transition. Someone that has been doing a lot of thinking on this specific topic, how to measure transition risk and what sort of data would give investors a helpful signal is Chris Cote, out of MSCI's Boston office. And over the past few months, Chris has been meeting with different MSCI clients to workshop different ideas and approaches.

Chris Cote

There's really a variety of approaches our clients are using today to make these transition assessments to understand risk. There are common starting points. Clients want to understand the emissions' intensity of firms, they want to understand the exposure to clean tech businesses like renewables and wind and solar if they can, and they want to understand targets. And a big part of the reason why these are common starting points is that these are the data points that are most scalable across a large number of firms. But there are additional questions beyond this, right? That's a great starting point. But the question that faces many of our clients, and to be candid, us here as well, is where do we go from here?

What's next? How do we enrich that assessment? How do we begin to understand supply chain risk? How do we understand technology risk in a scalable way that's not totally bespoke company by company? How do we understand policy risk in a way that can be translated across firms that operate in five to seven different markets and aren't dependent on the four elections that are happening in seven of those markets in the next two months, but can give a more general but still useful view?

Bentley Kaplan

So if you listen closely to Chris there, things start off in pretty familiar territory. Things that have been measured for years and have a comforting, simple numerical quality. Greenhouse gas emissions scope one and two. Heck yes, we know that. Even scope three, it may be tricky to measure. Sure there's debate, but we have all these great categories to think about so we're well on the way there as well. But then the more Chris spoke, the slower my head started nodding, policy risk kind of targets exposure to different clean tech revenue. Sure, sure, that's good. I'm good.

But then it's onto supply chains and financial considerations and things are starting to feel less like a familiar storybook and more like Charlie Day talking about the mail room. And anyone going into this challenge of measuring climate transition risk is going to bump up against this challenge, of finding something to sort of anchor all of these different moving pieces. For Chris through his many discussions with investors and many, many hours in front of imaginary cork boards covered in drawing pins and post-it notes, order did start to emerge from the chaos. And it emerged with this idea of technology as an organizing principle. Technology, its development and its uptake, and how that might ultimately determine a company's climate transition risks and opportunities. And once you've collected all of these different pieces, you need to figure out how they all fit together. Well, not you necessarily or me, but definitely Chris and definitely some of my more resilient MSCI colleagues.

Chris Cote

All of this falls under the umbrella of transition plans. That's a buzzy term that's much discussed now. But transition plans are only one piece of the puzzle, right? So they may tell you how a company is getting along in its transition, but an important question is how much does transition actually matter for these companies? And one area where we've done a lot of research is to understand the commercial adoptability of technologies. We know it's not just cost parity that makes or breaks whether a technology is adopted and really takes off in the market.

Do we really think that these technologies are going to scale quickly or do they just look nice on paper, but maybe face really high hurdles to be used on a day-to-day basis? We can use this information and translate it back into risk. So it may be that a company has really high emissions' intensity, like steel or chemicals or cement manufacturing, and we know that there are alternatives out there. But are those alternatives actually going to come into play anytime soon? I think that begins to get at the level of investment-oriented question that investors are asking today.

Is this really going to change the business profile that I'm looking at now? Or is this something I should worry about more in the next 10 years rather than the next five years?

Bentley Kaplan

So I did say that figuring out the financial risks and opportunities that investors face from a climate transition would sound pretty straightforward, but it would offer an abundance of discussion. There was a lot more where that came from, but I think we covered the basics pretty well. And I know this isn't going to be the last that we hear from Chris or about a transition risk signal. Now my last guest is Michael Ridley based out of MSCI's London office. Michael leads our ESG and climate research team across fixed income and has published several recent papers on some very intriguing topics.

If you don't believe me, just drop in to MSCI.com and see for yourself. Reading through Michael's research and hearing him talk about how the climate transition is being approached in the bond market, reminded me a lot of what Meggin said at the outset of this episode. Different investors will have different mandates and different approaches. And that depending on those approaches, a climate transition will mean different things and require different action. So I asked Michael to set the scene for me to explain where the climate transition was playing out in fixed income.

Michael Ridley

Well, thank you, Bentley. I mean, I suppose in terms of transition in the fixed income market, a place we should probably start is the labeled bond market. I mean, this has been in existence since 2008. What I'd say here is actually the labeled bond market is in fine fettle, 2024 may well be the second-largest year for annual issuance after 2021. Bear in mind as well that we've now got nearly $4 trillion worth of label bonds outstanding. So the market is becoming fairly substantial. We continue to see the percentage of market segments that are green or label, I should say, growing. So for example, we think that of corporate bonds outstanding, 6.2% of those globally are label.

Bentley Kaplan

Right, so we've spoken on the show about green bonds. And green bonds are one component of a broader labeled bond market, which also includes social bonds, sustainability bonds, and sustainability linked bonds. And as Michael tells it, the labeled bond market is growing. But when it came to the question of fixed income and the climate transition specifically, our new guest became a little more pensive.

Michael Ridley

I guess pause for question or concern is around the fact that we've noticed that companies in hard to abate sectors have been issuing sustainability linked bonds rather than green. So a number of aluminum, steel and cement firms have been issuing SLBs, and it's sort of causing some people to revisit the debate we had back in 2018-19 as to whether we actually need a separate transition bond label. So three reasons people are talking about that, not just because of the hard to abate issuing SLBs. We've also seen substantial transition bond issuance by the Japanese sovereign in yen, and they put out a big transition bond framework document as well to accompany that.

And the third reason is Singapore taxonomy, which is a really interesting document. They've done a lot of thinking about what they call amber activities, which is basically transition activities. And not only that, they talk about things like sunset clauses. So in different sectors or different parts of the world, you might be allowed to undertake amber activities through to 2030 or even 2035 depending on which part of the world you are. So in other words, transition activities could be allowed to continue for a while before eventually you have to choose whether it's green or not.

Bentley Kaplan

Right. So as Michael sees it, transition-specific bonds might well be an area that's worth watching. Companies that don't have easy access to low carbon activities might find it hard to raise debt through green bonds and are turning instead to sustainability linked bonds. It's a topic that we've discussed on the show before. It basically allows companies to tie coupon payments to specific sustainability outcomes rather than specific activities as you would in a green bond. And the Japanese government has issued relatively sizable transition bonds and plans to offer more in future.

Take that in combination with transition aligned allowances in something like Singapore's green taxonomy and Michael sees the use of transition bonds as an increasingly debated topic. A company issuing a bond may be at risk of stranded assets or at the other end of the spectrum it may be providing climate change solutions. And because of that, investors may assess those bonds differently. Or beyond single issuers, when aggregating a whole bond portfolio, investors may be asking questions about its alignment with a net-zero investment framework, or how to figure out a low carbon transition glide path to move towards lower emissions.

And whatever strategy or approach an investor opts for, it's going to become increasingly clear that we have left the days of bold claims and promises behind, and we're very much into the part where the climate rubber hits the investment road or the investment rubber hits the climate road. It really is your call.

And that is it for the week. A massive thanks to Meggin and Chris and Michael for their takes on the news with the sustainability twist. And a special shout out to Rumi Mahmood from the MSCI Sustainability Institute for his crib notes on the state for transition funds. Check out a blog that he co-authored with Xinxin Wang and Shuang Guo. It's up on MSCI.com and no opportunity wasted, it's called "Olive is the New Black, the Rise of Transition Funds".

I also do want to say thank you very much for tuning in. If you like what we're doing, then let us know. Drop us a review, rate the show on your platform of choice and tell a friend or colleague about this episode. Thanks again, and until next time, take care of yourself and those around you.

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