Fighting climate change: measure, model, act, repeat

RLAM has long advocated the need for our sector to be good asset owners and consider climate change. This means considering both how we as a manager impact the climate, as well as how the climate, and more broadly the fight against climate change, can impact us and the assets that we manage. For the former, this means considering the carbon output of our holdings – like all asset managers, our investment holdings are the major contributor to our carbon emissions (see figure 1). For the latter, this means undertaking the necessary research to ensure that we understand and are aware of any risk to the value of our investment, either due to physical damage as a result of climate change, or a shift in the business environment by means of changes to legislation or technological development.

Figure 1: Summary of emissions scope 1, 2 & 3

Scope	Total	Explanation
Scope 1	0.19 tCO_2e	Emissions from operating our business[1]
Scope 2	69.80 tCO_2e	Electricity and heating in our offices[2]
Scope 3 – direct	15 tCO_2e	Air and rail transport from our staff
Scope 3 – investments	5.34 $MtCO_2e$	Total scope 1 & 2 emissions associated to investments[3]

Source: RLAM proprietary and MSCI data as at 31 December 2020. Please note the different unit of measurement for the investments sub-category of scope 3 emissions – $MtCO_2e$ – which reflects millions of tons of carbon dioxide equivalent.

Measure

During 2020 we evaluated the best metrics to measure risk and opportunities within our operations and investments. The systematic disclosure and analysis of climate data across multi-asset investment strategies and hundreds of portfolios is complex and challenging – our objective was to find the clearest and most decision-useful approach to climate disclosures. We are only at the beginning of our journey and it is possible that 2020 data may not be comparable to future years, as regulation and reporting on climate is still immature, and the landscape may develop rapidly. It is also very likely that 2020 will not be a suitable baseline for future comparison, as the impact of the coronavirus pandemic on economic activity saw emissions decrease globally.

The metrics we selected will help our risk management teams, our leadership team and fund managers to integrate climate considerations into the various processes. In particular, and as recommended by the Task-force for Climate Related Financial Disclosures (TCFD), we started using the 'weighted carbon intensity' (WACI) metric to inform some of our investment decisions and to communicate with our clients.

RLAM's overall weighted average carbon intensity is 31% below its aggregated benchmark (see figure 2). The outperformance is mainly driven by a relatively lower weighting in high-carbon emitting sectors, such as oil & gas and industrials. Over 30% of WACI for our equities and fixed income investments stems from exposure to the energy utilities sector, reflecting both RLAM's preference for holding and lending to the sector, as well as its relatively high carbon intensity.

We also used metrics to evaluate our exposure to brown and green revenues (see figure 5). We define brown revenues as those obtained from any fossil-fuel activities in oil and gas, thermal coal mining and thermal coal generation; we define green revenues as those obtained from activities associated with climate and natural capital solutions.

Companies with revenue associated to fossil fuels constitute 8% of our overall assets, while the aggregate benchmark has 12% exposure, meaning RLAM has 36% less exposure to fossil fuels than the benchmark. However, RLAM marginally underperforms the benchmark with respect to green revenues from climate and natural capital solutions (23% versus 26%). Both these are a result of RLAMs reduced exposure to energy sectors, which both helps us to reduce the revenue generated by fossil fuels, but also limits our access to revenues from renewable energy sources.

While we have made a good start in tracking and disclosing our impact on the climate, it is important to stress the limitations of emissions data at present, particularly for fixed income assets. We find that the data coverage from typical ESG (environmental, social and governance) data vendors is often very low for this asset class. To combat this industrywide shortfall, we developed an in-house carbon intensity tool in 2020, which extended carbon emissions data for our fixed income holdings from 70% to 84% coverage of our portfolios. We continue our efforts to expand the data quality across asset classes and their benchmarks.

Model

Modelling is a forward-looking process which we undertake via scenario-analysis and stress-testing. It helps us determine how our holdings will contribute to global warming (warming potential), how climate change may physically impact the assets we manage (physical risk), and the risks which policy and technologically driven changes pose to our assets during the transition to a cleaner and more sustainable economy (transition risk).

In 2020, our analysis for Paris-alignment, which predicts how closely the warming potential of assets aligns to that targeted by the Paris

Figure 2: Weighted average carbon intensity tCO_2e/\$m revenues

Figure 3:
Weighted average carbon intensity by sector – equities

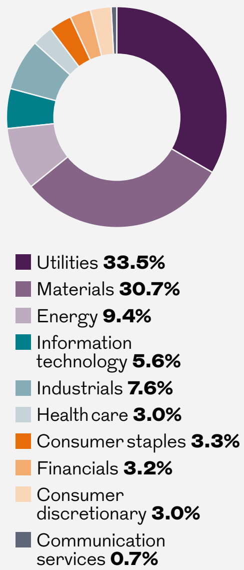
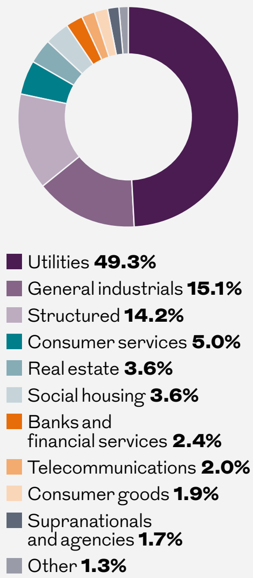


Figure 4:
Weighted average carbon intensity by sector – fixed income

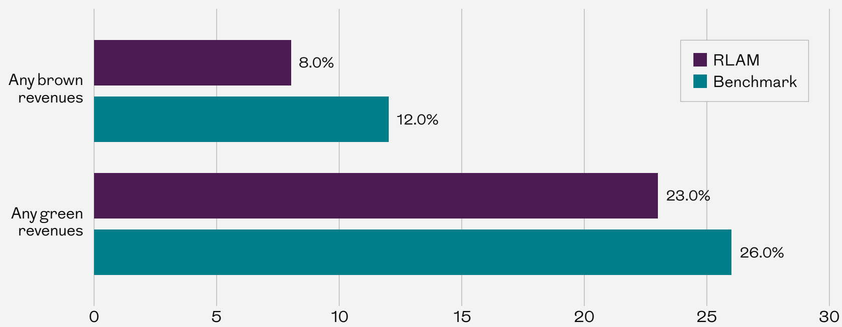


Figures are subject to rounding and therefore totals may not always equal 100%.

Source: RLAM proprietary and MSCI data as at 31 December 2020

Note: See our full TCFD Report 2020 for further detail across the wider asset-class mix, including sovereign debt and property.

Figure 5: Exposure to brown and green revenues



Source: RLAM proprietary and MSCI data as at 31 December 2020

Accords, covered 84% of our assets. In comparison, only around 30% of our assets – equities only – were covered by scenario analysis, which modelled the potential impacts of transition and physical risks on our assets. When it comes to decision making, we favour use of the warming potential metric, because with fewer assumptions in the modelling, we feel it is a more reliable metric. In comparison, scenario analysis takes us a step further away from climate science. Although the testing may provide more specific information, such as the potential change to a company's valuation due to climate risk (known as climate value-at-risk, or C-Var), it introduces many more assumptions into the modelling process, making the final result less reliable. This does not mean scenario-testing is not valuable, however we must use the results in a different way. For example, the direction of change in a price (is the price increasing or falling) is likely to be more important than the extent of the change.

Across the entire investment portfolio, RLAM's estimated firm-wide warming potential is 3.66°C and is therefore not aligned with the Paris Agreement (see figure 7). However, the estimated portfolio temperature is 0.02°C below the benchmark, or 1% better. These estimations include issuers' scope 1, 2 and 3 emissions, so the full impact of our portfolio holdings (return to figure 1 for definitions of scope 1, 2, and 3 emissions).

Act

RLAM uses four key strategies to fight climate change: climate integration, stewardship, advocacy, and communication. And while we use these tools across a range of themes, climate is a distinct strategic priority at RLAM. Not only is climate included as one of six key thematic engagement priorities for the firm, but it was the most engaged upon topic in 2020, representing almost a third of all company engagements (see figures 8 and 9). Furthermore, through the cycle of measure, model, act, repeat, we use our measurement and modelling to guide our activity. For example, with utilities being the major contributor to our WACI, we focus intently on this sector (see activity box below). We also used the same analysis to help develop our strategic policy commitments, our climate integration process, and our stewardship, advocacy and communication activity. Details of all our processes and activity can be found in our Climate Risk Policy, TCFD Report 2020, and Stewardship and Responsible Investment Report 2021.

Figure 6: Summary of forward-looking climate metrics for equities, corporate debt and sovereign debt

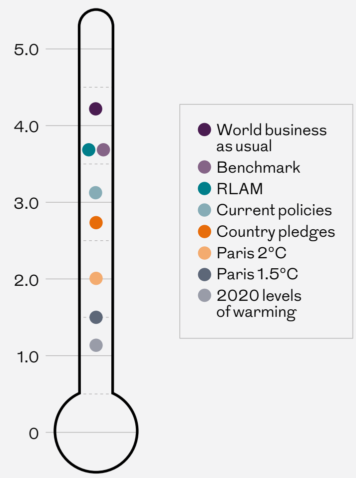
	RLAM – equities	**Benchmark**
Warming potential (°C)	3.44°C	3.59°C
Coverage (% of portfolio value)	72%	75%
Performance vs benchmark	4%	–

	RLAM – corporate debt	**Benchmark**
Warming potential (°C)	3.44°C	3.59°C
Coverage (% of portfolio value)	72%	75%
Performance vs benchmark	-2%	–

	RLAM – sovereign debt	Benchmark
Warming potential (°C)	3.22°C	3.19°C
Coverage (% of portfolio value)	72%	75%
Performance vs benchmark	1%	–

Source: RLAM proprietary and MSCI data as at 31 December 2020.

Figure 7: Implied temperature rise °C (warming potential)



Source: RLAM proprietary and MSCI data as at 31 December 2020.

Figure 8: Climate-related engagement

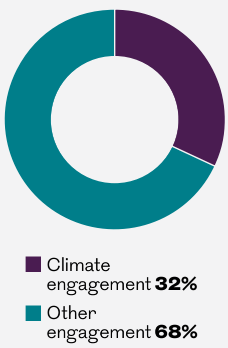
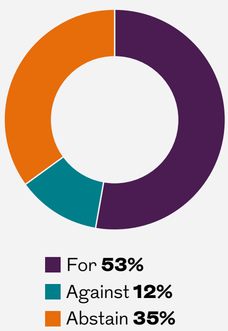


Figure 9: Votes on climate proposals



Source: RLAM.

Activity

What are we doing to mitigate our carbon risk exposure to the utilities sector and to benefit from the energy transition opportunities?

1 We co-lead the Institutional Investors' Group on Climate Change (IIGCC) power utility sector working group, which drives forward CA100+ engagements for thirteen European utility companies.

2 We partnered with the Friends Provident Foundation to engage with the seven largest utilities in the UK on social and climate issues. We scrutinise companies' assumptions and the alignment of their business models, infrastructure, and investment pipeline to the principles of net zero. We suggested the inclusion of a dedicated Just Transition strategy; of the seven utilities firms we approached, SSE and E.ON have published a strategy, while Centrica, EDF, National Grid and Scottish Power have committed to publishing. Only RWE has made no such commitment.

3 We co-authored and published a paper: Accelerating the Transition to Net Zero Emissions in the Power Sector, presented in the 'Race to Zero' dialogues as part of the UK Government's COP26 presidency efforts.

4 We reached out to the utility sector regulator in the UK, Ofgem, to request a revision of their Revenue Using Incentives to Deliver Innovation and Outputs-2 (RIIO-2) 'Draft Determinations for Transmission, Gas Distribution and Electricity System Operators'. We urged them to reconsider the achievable level of returns to ensure it is sufficient enough to attract the investment required to achieve net zero.

The views expressed are the author's own and do not constitute investment advice.

To find out more about our approach to stewardship and responsible investment and read our 2021 report visit rlam.co.uk/SRI

Notes

1 The only scope 1 emissions are from two company cars.

2 We have used the location based method to calculate these emissions as opposed to the market based method.

3 Calculation based on equity ownership portion method using Market Capitalization as denominator, with 97% coverage of emissions for our Equity portfolio (c.a. 30% of our AUM). Extending calculation to estimated Scope 3 emissions of our investments for the same portion of our Equity portfolio results in 39.39 $MtCO_2e$.

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For more information about our range of products and services, please contact us.

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