

Environmental, social and governance spotlight

Time to ditch materials stocks? Not so fast...

To reach global emission targets, it is imperative we embrace companies in the materials sector transitioning to more sustainable models within investment portfolios, according to James Clarke, Senior Fund Manager at Royal London Asset Management. Some investors shun carbon intensive sectors, despite them taking significant steps towards cutting carbon emissions.

Here, James Clarke explains why we should be willing to consider all investment cases that yield a reduction in climate change – wherever that may stem from.

ESG investing – it's not clear-cut

Some investors will only consider companies with low or zero emissions. But the reality is not so simple. The modern-day economy is reliant on fossil fuels and that will not stop overnight. It will take long term efforts to alter deeply ingrained practices gradually and methodically. Unless carbon intensive industries are addressed, decarbonisation will not occur to a significant enough extent to avert a climate catastrophe. For investors, that means embracing companies in transition.

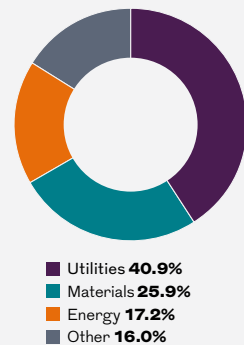
The production of materials is a significant source of greenhouse gas (GHG) emissions. According to Fishedick, M. et al. in *Climate Change 2014: Mitigation of Climate Change*, the ten years to 2015 saw GHG emissions from material production soar by 120%. As a proportion of global emissions, materials production rose from 15% to 23%. When accounting for the use of materials in the production of other materials, this meant 31% of all emissions were caused by materials production. For these reasons, it will be essential that investors embrace materials companies in transition to a greener future, to hit climate emission goals.

Fifty shades of green?

Climate change represents the greatest challenge to global sustainability, as it has the potential to destroy future generations' ability to meet their own needs. Our investment approach focuses on long-term shareholder wealth creation that is aligned with a strategy of global climate risk mitigation – ultimately climate instability threatens all businesses and societies globally.

We recognise that achieving sustainable climate change will require significant climate mitigation actions from the companies we invest in. The higher GHG emitters are required to reduce their emissions towards net zero as a pre-requisite to meeting the targets set out in the Paris Agreement. We do not believe a widespread exclusion policy,

Figure 1: Sector weight versus contribution to emissions



Source: MSCI ACWI, 21 Sept 2015

to simply avoid high current emitters, is the best way to achieve this transition. Our focus on climate mitigation is therefore on promoting corporates with high current emissions to accelerate decarbonisation towards net zero by 2050 or earlier. We consider mitigation efforts to be most credible if there are tangible improvements by 2030, as it is all too easy to present a 2050 vision without realistic milestones.

In our view, this can be achieved by:

- 1 Identifying companies, via our internal research, with current high emissions that are willing and able to reduce these in line with the Paris Agreement goals, including tangible 2030 improvements.

2 Engaging with specific companies to adopt robust net zero commitments and influence demonstrable real-world outcomes that increase chances of successful mitigation.

3 Avoiding or selling companies that are not willing or able to mitigate high emissions, in a credible or fast enough way.

But value isn't only added via returns; often lower risk is just as valuable. If you can recognise where the social landscape is changing quicker than companies can adapt – avoid management with damaging incentives and weak governance, or side-step climate change transition risks – you can lower portfolio risk. Although less glamorous, avoiding investment losers can be just as valid as picking the best winners. There is no doubt in our minds that if done right, ESG integration adds investment value for our clients.

Through our process we identify three broad categories of companies with material ESG issues: (i) 'clearly positive', (ii) 'challenging but attractive', and (iii) 'clearly negative'. 'Positive companies', like those who are part of the environmental solution in clean tech, can be great investments – the challenge however, can be buying them at an attractive price. 'Clearly negative' is a deal-breaker for us and we avoid them – a well-known UK example is Provident Financial, which we considered and passed on due to social risks – six months later it collapsed.

The heat is on

The mining sector is very intriguing but an area of great paradox. On one hand, mining companies are almost vilified for their significant part to play in contributing to global carbon emissions, but on the other, the raw materials they make are of extremely high importance to society in terms of building houses, hospitals and other important infrastructure needed for daily life.

Anglo American – a leading diversified mining company – is a good example of a business facing material environmental risks and rewards. It has legacy thermal coal assets which may well be impacted by fossil fuel transition and obsolescence risk but equally it

produces large quantities of rare earth metals, essential for renewable and carbon capture technologies. Beyond the investment opportunity, there is also a chance to make a difference. Anglo American has committed to reducing GHG emissions by 30% by 2030. Because it is such a large company, this 30% is the equivalent of 60 of the FTSE 100's lowest emitters going carbon neutral. Therefore, there is an incredible opportunity here.

Another materials company we hold is Steel Dynamics. Based in Fort Wayne, the steel company is among the leading steel producers and metal recyclers in the US, making steel products. It processes and sells recycled ferrous and non-ferrous metals, as well as makes steel joists.

Steel Dynamics has a number of green plus points – 83% of its inputs are recycled and 77% of these are sourced within 250 miles of a mill, therefore reducing carbon footprints.

Time for reflection

Ultimately, the materials sector is a pre-requisite to the daily operations of the global economy – investors just can't ignore this area, hope for the best, or worse and pretend it doesn't exist. That's why we believe it's better to invest in leaders like Steel Dynamics, who use newer, cleaner steelmaking technologies in the production process, to reduce environmental and economic harm.

The mass disruption of Covid-19 has been a big loud wake-up call for the world and cast light on the harsh reality for the future if we don't take action fast – the economic and social devastation that climate change will bring with it.

Risk warnings

The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

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