



Should investors steer clear of companies with large carbon footprints?

Some commentators have claimed that investors still do not fully understand carbon risk and are not sufficiently rewarding companies that are tackling climate change. We believe this assertion is wrong. It seems to be predicated on the erroneous assumption that the size of a company's carbon footprint provides a meaningful measure of its exposure to climate change risk, in a financial sense, and of its ability to profit from related opportunities. It also disregards the reality that investors consider a whole series of factors beyond climate change – for example, the nature of the company's activities, the quality of the company's management, cash flows and balance sheet strength – when making investment decisions.

In relation to climate change specifically, prudent investors consider not only total greenhouse gas emissions but also:

- The likelihood that the company will be required to reduce some or all of its greenhouse gas emissions.
- The degree of emissions reductions that are required.
- The timeframe over which the emissions reductions are required.
- The cost to the company of reducing or offsetting its emissions.

While this may not be of much comfort to those who would like to see stronger correlations between the size of a company's carbon footprint and its share price,

it does not mean that investors are ignoring climate change in their investment decisions. Indeed, for companies in sectors where climate change presents a (financially) significant risk or opportunity (e.g. those sectors covered by the EU Emissions Trading Scheme), the 'cost of carbon' is routinely considered in investment analysis. Furthermore, in recent years, global investment in climate change solutions, including alternative and renewable energies, has increased dramatically; some US\$66 billion was invested in new renewables capacity in 2006 alone and sectors such as wind are presently showing growth rates of 25% to 30% per annum.

A challenging investment environment

This is not to imply that investment analysis is perfect or that all investors fully account for all of the risks and opportunities presented by climate change. There are three major barriers to the fuller integration of climate change into investment analysis:

1. The lack of policy certainty beyond 2012 and the absence of a 'price' for carbon for many sources of emissions.
2. Weaknesses in corporate disclosures that make it difficult for investors to make meaningful comparisons between companies.
3. Difficulties in assessing the risks presented by the physical impacts of climate change.

Investors' responsibilities

Professional investors do not have an open mandate: they have a duty to invest in line with their clients' financial objectives, which usually entails delivering a specified investment return within specific risk boundaries and over client-defined time horizons. In the absence of explicit client requirements, investors may find it difficult to invest in companies that are tackling climate change or that have specific greenhouse gas emission characteristics.

This is not to say that investors' hands are completely tied. They can do a lot to encourage the right conditions for climate change risks and opportunities to be adequately considered in investment analysis and decision making. With regard to the barriers identified above, investors can engage with governments on public policy on climate change, can encourage companies to improve their climate change disclosure and management of climate change risks, and/or can support further research on the business risks presented by changes in weather patterns.

These are all, to a greater or lesser extent, currently being done. For example, in relation to public policy, investor bodies such as the Institutional Investors Group on Climate Change (IIGCC) and the Association of British Insurers (ABI) have supported the establishment of long-term greenhouse gas emission reduction targets, and have encouraged companies and government to support and work towards these targets. This should encourage governments to establish the policy frameworks necessary to support companies involved in finding solutions to climate change, and should strengthen the link between climate change performance and financial performance (as measured by share price or the cost of capital).

Conclusion

Investors have an important role to play in creating a low carbon economy. However, we think it is incumbent on all parties to understand the nature of investors' responsibilities and the degree of investor influence. The suggestion that investors should, as a matter of course, and in the absence of appropriate public policy or explicit client requirements, invest in companies because they meet green criteria is simply misguided.

February 2008

Produced by the Insight Investor Responsibility Team

Web: http://www.insightinvestment.com/responsibility/investor_responsibility_home.asp

Tel: 020 7321 1162