ESG Now Podcast

"Tracking our climate goals and next steps"
Transcript, 19 May, 2023

Mike Disabato: What's up everyone? And welcome to the weekly edition of ESG Now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host Mike Disabato, and this week we discuss if publicly listed companies are making progress on their net-zero goals and what could be done right now to slow the world's carbon emissions. Thanks as always for joining us. Stay tuned.

Are you aware of how much progress we are making on addressing climate change? I don't know if I am. It's difficult to know. There are all these pledges and all these plans companies are making, but have those plans been useful? Are they actually making progress on cutting emissions or are they just saying, "Yeah, we care about it and we'll do something."

And what are those somethings? Are they far away technologies that can suck bad stuff out of our atmosphere like some sort of techno savior? Or are they simple like companies that replace dirty cooking stoves with clean ones? And will that be enough if that's true?

Well, if you're like me and you're having trouble sorting through all this climate mess and not getting anywhere, well then you're in luck because today I'm going to get people on here to answer all of your questions. And first they're going to fill you with dread, but then they'll provide you with a calming bomb of optimism for your weary souls.

So first, let's answer the larger question. Are we making progress in cutting carbon emissions? And I just told you I cannot answer that, so I am not going to be much help. But I know someone who can. My colleague, Sylvan Vastan. Sylvan was the lead author on a report we recently published called the Net-Zero Tracker, which is a quarterly report on the progress the world's listed companies are making toward curbing climate risk.

Now before we get into what Sylvan says, I have to quickly preface it. His views are his own and do not represent investment advice. That's important for us to get out of the way, but I got it out of the way. So when I called up Sylvan, I asked him one question, are the world's companies reducing their carbon emissions? And in his answer, he uses a couple terms that I want to define for you, so it's easier for all of us to understand.

He talks about the IPCC. The IPCC is the Intergovernmental Panel on Climate Change, which puts out all these really important reports on our abatement dub or abatement by climate change. He talks about the SBTI. The SBTI is the Science-based Target Initiative. And the Science-based Target Initiative is this kind of gold standard and vetting climate plans. Then he talks about ITR. ITR is our metric that we call the Implied Temperature Rise. And the ITR is how much warmer the world will become if the entire economy acted like a specific company in how much emissions it puts into the atmosphere. It's a projection, it's a number. It gives you a degree, like two degrees, 1.5 degrees, 2.7 degrees. That's basically what the world would warm up to if it acted like this company that we're assessing with the ITR.

So as you can see, that's why this question of are the world's companies reducing carbon emissions can get difficult at times. But here's Sylvan giving us a guide to how we should think about this.

Sylvain Vanston: What we find is more targets, better disclosures, but ever-growing carbon emissions. Obviously we'd rather have it the other way around, but the latest IPCC report tells us that there is still a window for achieving 1.5 degree, which is closing pretty soon. So yes, more targets, better disclosures, but more emissions.

We also see, so for example, we get 35% of ACWI IMI issuers disclosing their Scope 3 emissions. That's up I think by 4%, which is good because it's not easy to report on your Scope 3 emissions. It's difficult. We have 44% of issuers disclosing some kind of a decarbonization target. That's also up a few percent points. But only 17% are targets that align with net-zero, 1.5 degree as approved by SPTI, which of course is some sort of the gold standard in this space.

When you look at the temperature rating, so using MSCI's implied temperature rise, we see that the ACWI IMI global temperature alignment is now 2.7 degree, which is interesting because it is quite close to what you find when you look at government pledges. And that leaves us with 19% of issuers achieving a 1.5 or below ITR, which is again, not so bad. But as I was saying, carbon emissions are still on the rise.

Mike Disabato: Okay, so there you go, emissions are still on the rise. Everything keeps trending up. And what we say in the tracker is that by 2026, companies would use up their share, their individual share of global carbon emissions, their global carbon budget for keeping temperature rise below 1.5 degrees Celsius, which, okay, 46 months is pretty short. That's a little bit worrisome. It kind of puts into perspective the urgency here.

And so you hear that though, but what do you do about that? This is an investor-focused paper, the Net-Zero Tracker. So let's answer from an investor perspective. In the tracker, there are a list of sectors and we have their implied temperature rise next to them, which again is the number that says if the world's economy was acting like that sector, then the world would be headed toward a certain temperature rise. And there are four sectors that have an under 1.5 degrees Celsius ITR. They are biotech, telecoms, software and services, and insurance.

So I asked Sylvan, as an investor worried about that 1.5 degree mark, does that mean that I should rush out and move all my money into those four sectors?

Sylvain Vanston: That's a logical conclusion that some may follow. But obviously if you do this, what you're practicing is so-called paper decarbonization, not real world decarbonization. Because it is not financials or pharma or media companies that will fuel the bulk of the transition to a low carbon economy. It is energy company, it is cement, it is unfortunately the industrials which today have a high carbon intensity. That's why temperature ratings or portfolio alignment metrics are interesting because they go beyond current present day carbon emissions, carbon footprinting, and into projected emissions, taking also into account carbon budgeting, carbon budget logic, which is more interesting, more relevant.

If you are a large asset owner today with let's say annual reinvestment outflows of 30, 40, 50 billion euros or dollars a year, you can't just target 1.5 degree aligned issuers. You will not get there. You would be far too concentrated. You will stray from the branch mark too much. So you do need to finance today issuers who display a high carbon footprint but are actively acting on the energy transition side. That means obviously an issuer by issuer level analysis of what they're doing sector by sector comparing to benchmark, comparing to peers, understanding the business models that they're working on.

Mike Disabato: Sylvan is talking about the problem called tracking error. And tracking error is when your investments deviate from a benchmark that's supposed to represent a segment of the economy that you want to invest in. And when you deviate from your benchmark, your returns can vary a lot, and investors typically think of that as caring a lot of risks.

But what I want to focus on more than just tracking error is what he was saying about needing to invest in companies that are making a transition away from carbon intensive production. It is that transition that is important at the moment rather than just investing in companies that are less exposed to carbon emissions due to their operations. After all, carbon emissions isn't an individual sector problem, it's an economy-wide problem. That is what Scope 3 emissions, for example, are really all about. It's not just the companies that make pollutive products, it's the companies that use them that need to be examined for how they are attempting to lower carbon emissions.

And for pollutive companies, if you decide to invest in them, Sylvan's view is that engagement is one of the larger theory of changes out there that can be used. Shareholder engagement is one way to work with the economy for the change you'd like to see. And the Net-Zero Tracker concludes with a discussion about what success might look like in terms of carbon emissions reduction. But I wanted to hear from Sylvan directly what he thought "success" was as it pertains to carbon emissions. Because we answered that initial first question put at the beginning of the show, have companies reduced their carbon emissions? The answer was no. So success and failure as binary as that, I asked Sylvan.

Sylvain Vanston: Obviously success should be defined as real world emissions going down, going down in line with the requirements that get us to net-zero by 2050. We're still very far from that. However, I think it's clear that the combined pressures from investors, from regulators, from the public, from NGOs, from media is pushing more and more companies, more and more issuers into setting their own targets.

And usually what we see, and it makes sense obviously, is that an issuer with a target is much more likely to reduce its carbon emissions than one without. If you're committing publicly, especially if you put this through your AGM, through shareholders, if you're an issuer with a target, you make it public, you organize yourself around it, you try to stick to it. You might not always achieve it, but at least you try to stick to it.

And so I think we have some good news in store in the coming years thanks to the growing amount of targets, but we need a whole lot more than that. When I was saying that 17% only of issuers have a proper net-zero target, this needs to ramp up, and also ramp up in some of the more how to abate sectors.

Mike Disabato: Okay, so the question then moves to are these sectors dragging their feet on setting targets because there are not ready solutions for them to transition with. A target set with no solution will just languish in the public eye and be embarrassing for the company in the long run, and nobody wants that.

So I turned to another colleague of mine that covers climate investment, Chris Cote, to answer that concern. Because he just published a report this week called The Climate Wake-up Call, which focused on what we can do now to lower our emissions as an economy, what companies could do. Because in his mind there is a lot that can be done to address climate change. And now in 2023, the stars are finally starting to align for us to do that.

Chris Cote: We already have a lot of what we need to get on the right path through 2030. In the short term, the challenge that we face is deployment, not invention of these tools. Wind and solar, these are tools obviously that we hear about all the time, that we know about, they can do a lot. We've definitely seen supply chain problems over the last few years and companies are facing grid connection issues, but the technologies at base are cost-effective thanks to decades of innovation. And we really now have industrial policies and key markets like the US and Europe that make deployment even more attractive. Tax credits through the Inflation Reduction Act, for example, came into law last August and companies are now beginning to take advantage of.

Mike Disabato: Most of those solutions will be extremely successful up until 2030, Chris was telling me. 2030 by the way, is when the governmental panel on climate change says that global average temperatures are estimated to rise to 1.5 degrees Celsius above pre-industrial levels unless we start to lower our emissions using those tools that Chris just mentioned.

But after 2030, the options become much more dramatic and much more expensive, especially if we don't do anything. Things like using green hydrogen or carbon capture and storage, the type of tech that still needs some runway and buy-in from other players than just investors for them to be ready to use.

Chris Cote: So there's room for policy here, there's room for other rules and regulations. But for investors, deploying capital to the solutions is really key. And we found also that companies more invested in this transition tend to do better. So they have faster earnings growth compared to peers earning less revenues from these climate solutions. This was true across the high emitting sectors of energy, utilities and materials. And so that's another reason for investors to act.

Mike Disabato: What Chris did there was he looked at about 9,000 publicly listed companies, a little bit over that, across all the industries that we cover. And he looked at those that had the highest share of revenue from alternative energy, energy efficiency and green building, within that universe, the top quintile. And he saw that over a period of roughly seven and a half years that ended on March 31st, 2023, these companies, the top quintile companies had significantly faster earnings growth than their sector peers. And it's a finding that can be reflected in some of those policies that Chris was alluding to earlier that are making these efforts more feasible than ever before to address climate change, the Inflation Reduction Act in the US and the European Union's Green Deal industrial plant. And though coal-fired power plants are still being built and used in China and India, and that's a complication of sorts, both countries are targeting massive investments in renewable power.

And all this is useful because it can push the developed market economies forward in this goal, and then there can be a global groundswell that helps rise not just developed market economies, but also those emerging market economies that are often more at risk to the problems of climate change. And I asked Chris about this and he said right now it's actually harder in emerging markets to amass capital for these type of projects, but there are some solutions already being put into play that he wanted to discuss.

Chris Cote: There are some interesting innovations out there with JETP for example, trying to do managed coalface out in Indonesia, Vietnam, South Africa. There's carbon credits for transition finance, which I think is going to be a big theme at COP28 in Dubai this year. And there may be more innovations coming from the World Bank and other multilaterals. I think this is one of the key areas of focus to get this right at a global level over the next 5, 10, 15 years.

Mike Disabato: To sum this all up, we are still pumping too much greenhouse gases into the atmosphere, but the problem now is deployment rather than invention. And that is what I and I think investors can take away from these two reports that we recently published. And that might not be the answer we want to hear at the moment, but at least things seem to be starting to align.

And that's it for the week. I want to thank Sylvan and Chris for talking to me about the news with an issue twist. I want to thank you so much for listening. I really appreciate it. If you like what you heard, don't forget to rate and review us. That brings us up on these podcast lists. More people can find us. It's useful. And subscribe if you would like to hear me or Bentley every week. Thanks again and talk to you next week.

Speaker 4: The MSCI ESG Research Podcast is provided by MSCI, Inc. Subsidiary, MSCI ESG Research LLC, a registered investment advisor, and the Investment Advisors Act of 1940. And this recording and data mentioned herein has not been submitted to nor received approval from the United States Securities and Exchange Commission or any other regulatory body.

The analysis discuss should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The information contained in this recording is not for reproduction in whole or in part without prior written permission from MSCI ESG research. None of the discussion or analysis put forth on this recording constitutes an offer to buy or sell or promotional recommendation of any security, financial instrument, or product or trading strategy. Further, none of the information is intended to constitute investment advice or recommendation to make or refrain from making any kind of investment decision and may not be relied on as such. The information provided here is as is and the user of the information assumes the entire risk of any use it may make or permit to be made of the information.

Thank you.