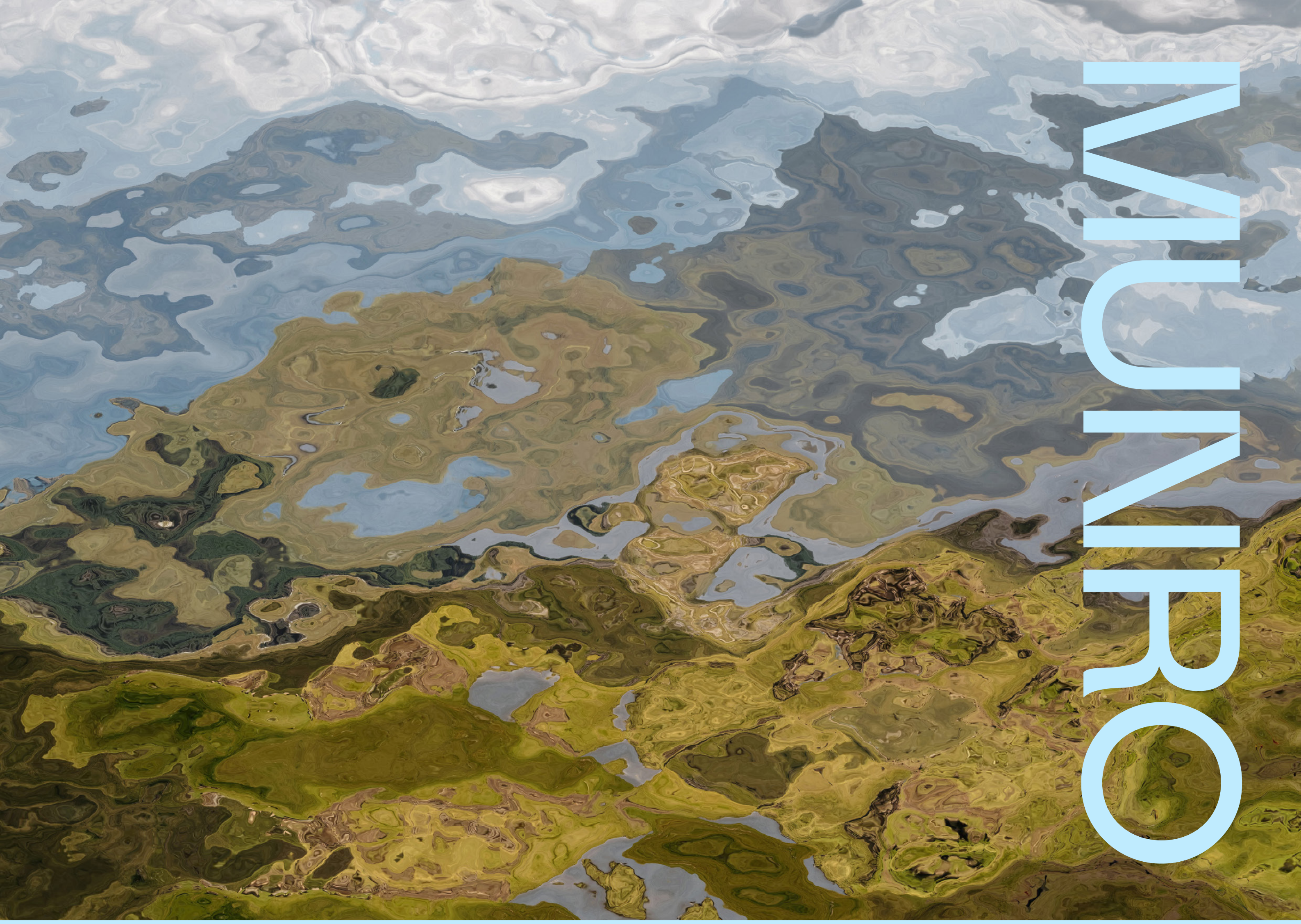


Area of interest

Investor climate action: not just about portfolio emissions

Investor climate action: not just about portfolio emissions

According to the IPCC, we are in the critical decade in the fight against climate change. To achieve a 1.5°C outcome, global GHG emissions need to reduce by 45% by 2030 and net zero by 2050.[1]

In response, many investors have adopted climate action plans. A feature of many such plans is to reduce their portfolio's emissions footprint (i.e. their proportionate 'ownership' of the underlying companies' emissions) in line with similar 2030 and 2050 goals.

We are supportive of the Paris Agreement and investors' role in decarbonisation. In fact, today one of our biggest exposure among our 20+ Areas of Interest is climate change, specifically companies that will enable decarbonisation. In this sense, we strongly support decarbonisation efforts and actively invest in companies making it happen.

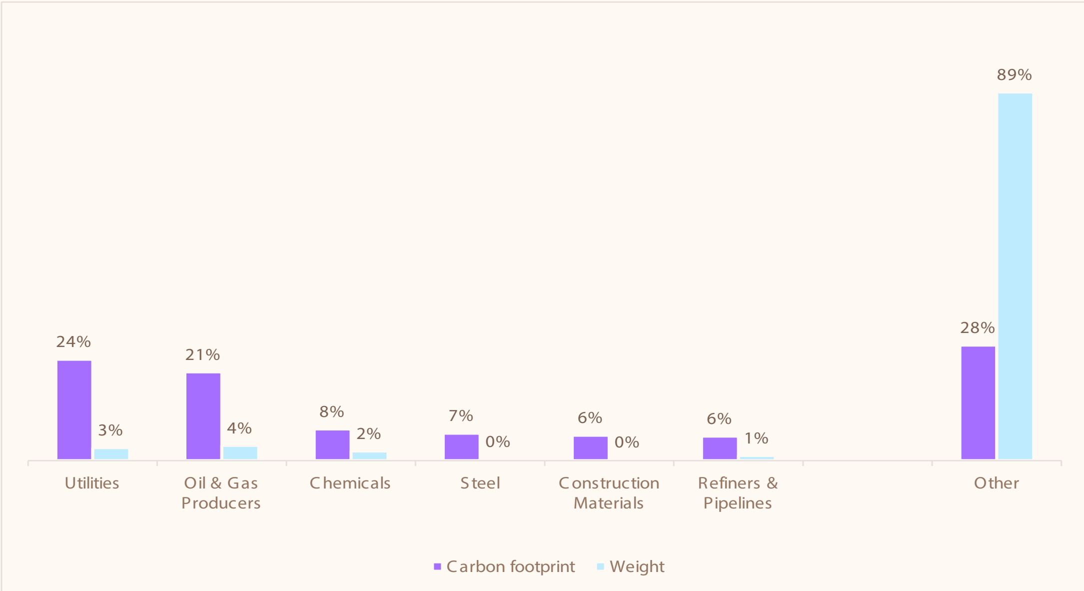
However, while we acknowledge the role of emissions reduction targets, particularly for large, diversified 'universal owners', they are not the only tool – and in some cases shouldn't be a big focus.

Below we outline why a broader approach is needed.

UTILITIES: CAUSING THE PROBLEM, BUT KEY TO THE SOLUTION

When we look at the largest listed companies globally, utilities make the biggest contribution to emissions. They represent only 3% of the index but 24% of the emissions.[2]

Climate footprint v MSCI ACWI weight



Source: IMSCI, Sustainalytics, Munro Partners estimates as at June 2022. Calculated as described in TCFD Implementing Guidance Annex 2021 (p50). Accessed here

Superficially, the sector appears to be the biggest source of the problem and so should be the first sector where investors focused on climate change should reduce exposure. But this ignores two crucial issues.

First, unlike some of the other sectors in the graph, there are economically and technically viable paths for utilities to decarbonise. They won't be number one for long.

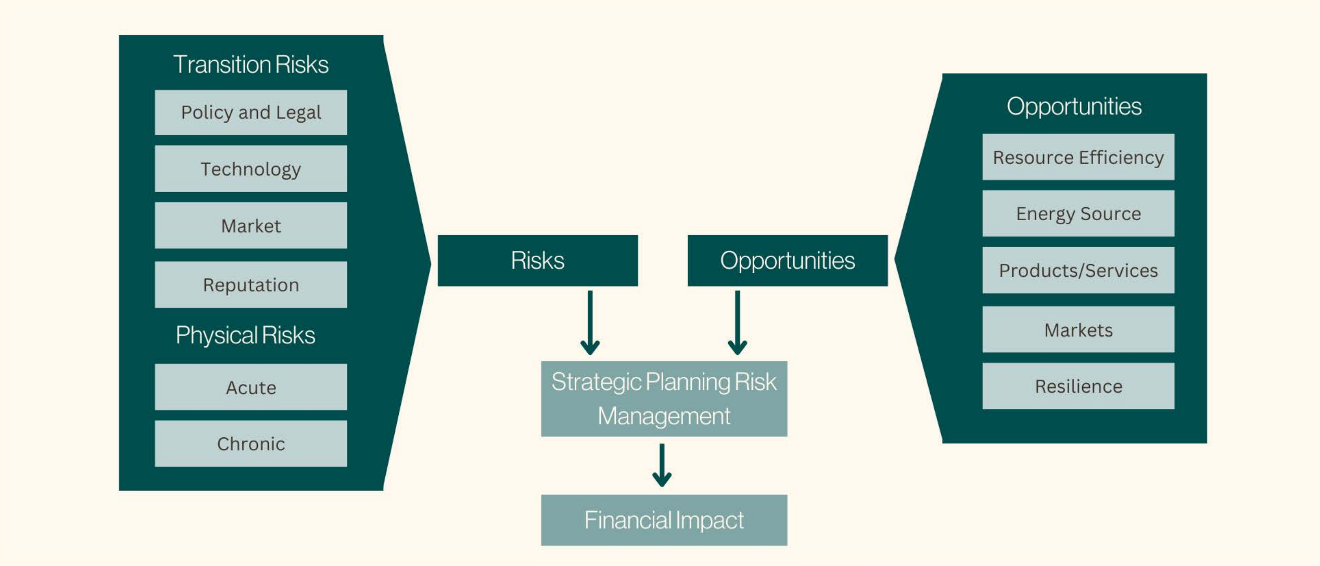
More importantly, decarbonisation means electrification and utilities are at the centre of this. And a clean grid enables others - like light vehicles - to decarbonise. For instance, the lifecycle emissions of an electric vehicle charged off today's grid are around 30 tCO_2, compared to an internal combustion engine of 70 tCO_2.[3] But the 30 tCO_2 reduces in line with the reduction in the emissions of the electricity source.

For this reason, we consider utilities such as NextEra Energy, RWE and American Electric Power as enabling decarbonisation despite them having relatively high operating emissions today. More on them later.

HIGH EMITTING CLIMATE SOLUTIONS? YES!

The TCFD framework[4] has a simple and elegant graphic showing how climate change impacts companies and investments:

Climate-Related Risks, Opportunities and Financial Impact



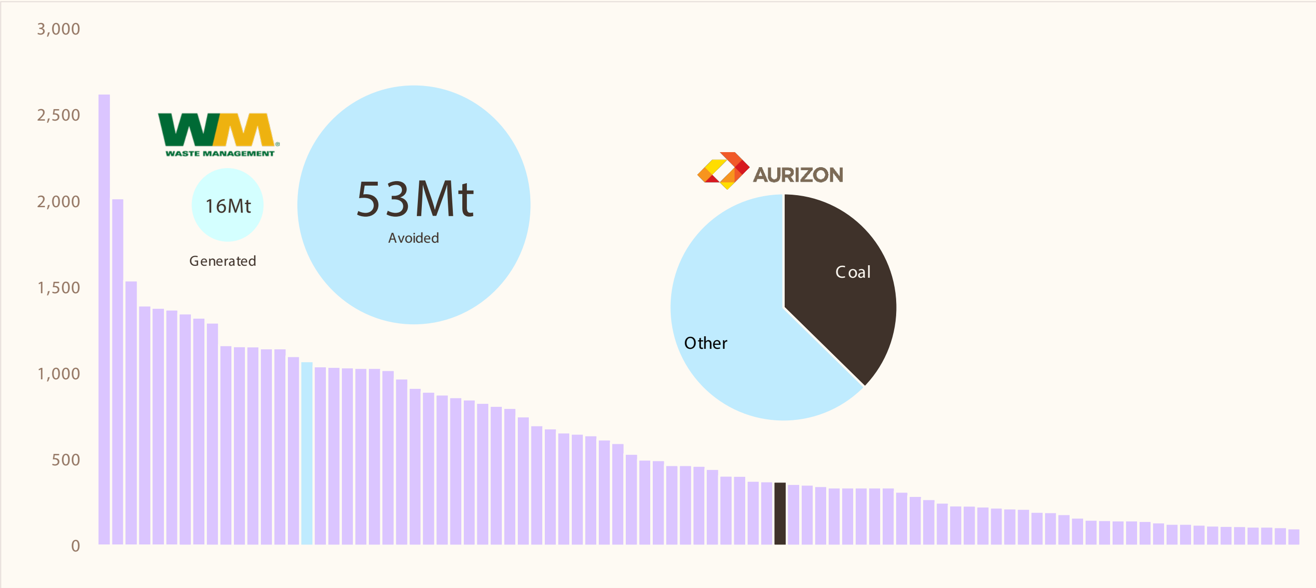
Source: Recommendations of the Task Force on Climate-related Financial Disclosures (2017). Accessed here.

The focus for many investors is on the left side, but let's not forget the right side. In fact, Munro's entire focus is the right side. Our thesis is explained here.

A company's operational emissions tells you little about how it captures the opportunities from decarbonisation.

For example, below is the Industrials sector's operational emissions intensity with two companies highlighted.

Emissions intensity of global Industrials



Source: *Within MSCI ACWI, and with reported emissions data and >100t carbon intensity (CO2e/US$1m revenue)
Sustainalytics (June 2022), Aurizon FY22 Results, Waste Management Sustainability Report (2022)

Waste Management is in Munro's Climate Change Leaders Fund . It has relatively high operational emissions. But what's missing from this picture is that their activities help prevent more than 3 times that amount through recycling, capturing landfill gas and sequestration.[5]

Compare that to Aurizon. It has less than half the emissions, yet their earnings are driven by them transporting coal.

This example shows how companies with high operational emissions (like Waste Management) can provide solutions to climate change, and companies with relatively low operational emissions (like Aurizon) can remain firmly exposed to coal.

TWO MORE (BIG) THINGS

It's beyond the scope of this paper to go into the following two issues in any detail, but there are two other issues that carbon footprints obviously don't capture:

- **Physical risks:** Transition risks are just one manifestation of climate risk. The physical impacts are just as important, and increasingly so over time. A company's emissions tell you little about its exposure to physical climate risk.

- **Scope 3 emissions:** Portfolio emissions only measure a company's scope 1 and 2 footprint: direct emissions, plus purchased energy like electricity. This makes sense on a portfolio level, because otherwise there would be a lot of double counting. But for some companies (like oil and gas producers or car manufacturers) their scope 3 emissions, such as those from the use of their sold products, that are most material.

IT AIN'T WHAT YOU DO, IT'S THE WAY THAT YOU DO IT

For investors with emissions reduction targets, what matters is how they achieve them.

To understand this, imagine a listed electricity generator with high emissions that has two groups of shareholders. Group A care deeply about climate change and put in place portfolio decarbonisation goals. Group B don't.

It would be a terrible irony if the net result of portfolio emissions targets was group A selling their shares to group B. This would result in no net change to real world emissions. In fact, it will probably lead to pressure on the company to do less on climate change.

It would be much better if group A retains (or increases) their shareholding and uses their leverage to push the company to change. This will change real world outcomes.

Of course, leading frameworks such as Net Zero Investment Framework recognise this, noting that "... an investment strategy should prioritise engagement and stewardship...as the primary mechanism to drive alignment."[6]

Also, engagement works.

At the macro level, Climate Action 100+ has shown (admittedly slow but) steady progress among the world's largest listed emitters it targets. For example, between their March and October 2022 assessments, there was a 22% increase in the number of companies committing to net zero.

This mirrors our own experience. For example, in June 2022 we engaged directly with US utility American Electric Power on their emissions reduction targets, expressing our view that they could be further strengthened. In October, they announced plans to transition faster to 2030 and to bring forward their net zero date to 2045. We can't claim to be the only reason for their decision, but it shows how we can have an impact through engagement which we lose if we sell.

In fact, each of NextEra Energy, RWE and American Electric Power, which are all Munro holdings, have tightened their emission targets or fossil fuel phase-outs in the last six months.

CONCLUSION - NOT JUST ABOUT PORTFOLIO EMISSIONS

While a portfolio emissions target is an important tool, especially for a large, diversified investor, it's not synonymous with the risks and opportunities from climate change.

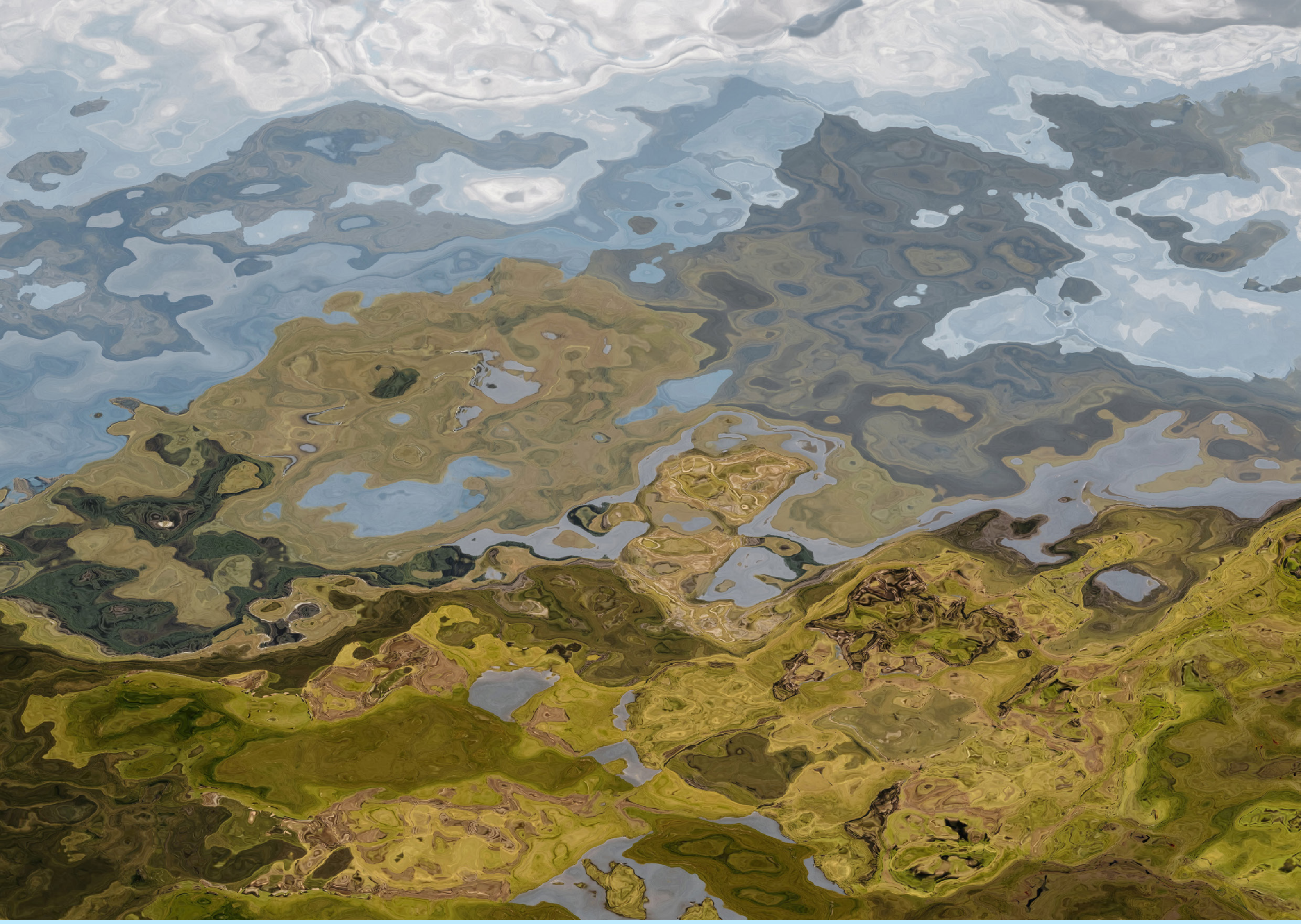
In fact, a company's emissions can obscure the role of utilities in the transition, and don't show exposure to climate opportunities, physical risks, or emissions in the supply chain. There is also a danger of them having the perverse effect of taking shareholder pressure off high emitters through encouraging divestment.

Therefore, for us the focus will likely remain less on portfolio emissions and more on investing in climate solutions together with active engagement.

This document is issued on 23 November 2022.

SOURCES

1 IPCC (2018) Summary for Policymakers. In: "Global Warming of 1.5°C. An IPCC Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways, in the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty" Accessed here.
2 MSCI, Sustainalytics, Munro Partners estimates as at June 2022. Calculated as described in TCFD Implementing Guidance Annex 2021 (p50). Accessed here.
3 Tesla Impact Report (2021). Accessed here.
4 Recommendations of the Task Force on Climate-related Financial Disclosures (2017). Accessed here.
5 Waste Management Sustainability Report (2022). Accessed here.
6 Net Zero Investment Framework (2021). Accessed here.



Munro Partners
Level 12
80 Collins St (South Tower)
Melbourne VIC 3000

+61 3 9290 0900

contact@
munropartners.com.au

Area of interest:
Climate