CIO Office

Sustainability Insights

COP26: take-aways for investors

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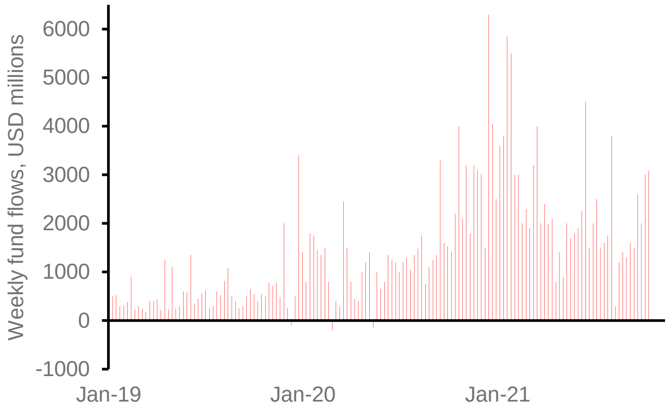
- Ahead of COP26, we set three criteria to measure success: detailed and ambitious goals to cut net emissions, the finalization of Article 6 (cooperation mechanism between countries) of the Paris agreement and the provision of USD 100bn of annual climate related funding for poorer countries. On these metrics, **COP26 had mixed results**, and the measures taken are not enough to limit temperature rises to 1.5°C.
- The agreement includes **lofty goals but misses the detail**, and many steps will not be taken immediately. On that point, the surprise US-China declaration to work together on many topics in the 2020s is a clear positive. But as investors wait to see the real action, a longer term approach to investing sustainably is probably required.
- **The COP26 agreement is still significant**. It is clear that there is a serious global multi-year effort to tackle climate change that includes all aspects, such as the reduction of coal, the development of clean technology, ending deforestation etc. The huge investments will extend economic growth but the costs could add to inflation.
- Every company in every sector will be affected by this in some way, through regulation, the rising cost of emissions, increased risk of stranded assets, and businesses needing to invest and adapt. As governments did not achieve many people's objectives at COP26, we think shareholders and society will put more pressure on the private sector to act. We therefore think that an **enhanced approach to sustainable investing becomes even more important for the core portfolio.**
- Global warming will continue for now, and both the mitigation and adaptation aspects of our Climate Change theme are thus very relevant. As for the energy transition, **we think countries and companies will pull out all the stops**, **benefiting all clean energy technologies**. But net zero needs progress in electricity generation, transport, industry, building and agriculture, and we see opportunities in all these sectors and in natural capital. We expect a big jump in green bond issuance, and financial firms should benefit from increased lending and investment activity.

Solidifying a long term trend

At the start of the conference, UK Prime Minister Boris Johnson said that 'if Glasgow fails, then the whole [climate fight] fails', and he put the chances of success at 6/10. Markets did not show any signs of exuberance either: the flows into sustainable ETFs did not accelerate going into the conference. The weekly flow pattern shows a steady increase in sustainable investing, which is more reflective of a long term structural trend than COP26 anticipation.

Weekly ESG ETF flows show a structural rise in investor interest



Source: Bloomberg, HSBC Global Private Banking as at 14 November 2021.

So, although most of the press, charities and commentators seem to be disappointed by the results of the conference (especially on coal), and Mr Johnson gave the final outcome a 6/10 score too, there should not be a big market-wide reaction as prior expectations were relatively low. Sustainable indices outperformed other benchmarks a little during the first week of the COP, and gave back these gains during the second week. We believe most investors will (and should) take a medium to long term approach to sustainable investing. In the words of Bill Gates: 'We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten. Don't let yourself be lulled into inaction.'

The fight against climate change is a long term effort. As most countries still need to spell out the detail of their policies, many investors may not want to jump to conclusions just yet and back one technology over another. But as markets usually try to anticipate future change and future profits, it is key that investors start to position for that opportunity.

Where are the opportunities?

From a thematic investment perspective, we think the Global Coal to Clean Power Transition Statement will be watched carefully as it could impact the future strategies of companies, which technologies will lead, and the carbon footprint of portfolios. Around half the technologies that we need to meet the climate challenge aren't yet commercially deployable and need to be rapidly scaled up. These include sustainable infrastructure, sustainable aviation fuel, hydrogen, and carbon removal technologies. We believe the recent spike in energy prices, and the recent shortage of coal and natural gas in Asia and Europe (and wind in the UK) will also focus minds, and help convince governments that they need an 'all-weather' approach with a broad-based energy mix (including geothermal, tidal, hydrogen).

Given the size of the challenge of tackling climate change, we think there are 5 anchors that will all need to be addressed. Most investors think first of electricity generation and cleaning up the grid. For many countries, this is often the first step, as abundant clean energy can make other downstream activities cleaner too. There is also well established technology – e.g. wind and solar – that is cost competitive. But countries that are already well advanced in this area, especially in the developed markets, will need to take steps around the other anchors. Those include transportation, industry, buildings and agriculture, and they are often more difficult or costly to achieve. Consumer behaviour shifts are necessary too and may only be gradual.

So the approach will depend on the country. In the US, there is a focus on transportation (electric vehicles and aviation fuels) and electricity. In the UK, emissions related to electricity generation have already been cut substantially, and increased focus is now on building efficiency and transportation. In the EU, there will be a focus on cars, building renovation and hydrogen. And in China, the government targets 80% of the primary energy mix to come from non-fossil fuels (including hydrogen, nuclear and renewable energy)), as well as focus on electric vehicles.

This list is not exhaustive, and many younger technologies could lead to good returns if they gain in efficiency or if countries (or coalitions of countries) choose to prioritise them. Finally, as this is a net-zero goal, we think that almost everywhere, there will be an increased focus on forest preservation. Therefore, we think natural capital is a rapidly growing asset class.

Conclusion

For our core portfolio, we believe ignoring ESG is no longer viable, and we need to use an enhanced approach or impact approach to ensure we fully reflect the potential risks and opportunities in this transition. Sustainability aspects are now so material that companies that try to make sustainability a competitive advantage will do better than others in the long run.

On the thematic side, our High Conviction themes of 'Climate change – mitigation and adaptation opportunities' and China's Green Revolution are very topical. While most of the global promises and targets have focused on mitigation, because countries benefit from each other's efforts, adaptation is crucial too. Developed countries generally have the means to adapt, but it will be important for lenders and green bond markets to provide the necessary funding to poorer countries or borrowers.

To end, allow me to make a philosophical refection. Earth was created around 5 billion years ago, and it may continue to exist for another 5 billion years until our Milky Way collides with the Andromeda galaxy. Through extraordinary luck, the conditions were right on earth for life to develop and prosper. But because of lack of knowledge and mismanagement, we are threatening that life on earth after just 200 years of GHG emissions, following the industrial revolution. We now have the knowledge, and we all have a role to play to stop the mismanagement, to become better guardians of our planet.

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Risks of investment in fixed income
There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

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