Addressing climate change: why cashflow driven investors should act now

Climate-aware investing can mitigate against an emerging and significant risk factor. This is essential for investors targeting predictability of cashflows alongside high resilience to market risks.

Highlights:

- Cashflows and climate are two of the most prominent themes for UK DB pension schemes
- Climate-aware investing aims to mitigate against the current and future, physical and transition risks associated with climate change as well as aligning portfolios to the 2015 Paris Agreement
- Mitigating climate-related risks could increase predictability of income for cashflow driven investors
- The long-term credit typically used in cashflow driven strategies has a natural alignment with the time horizon over which climate-related risks can materialise
- Climate-aware investing should help, and not hinder, the overarching financial objectives of schemes

Introduction

Pension schemes currently face two major challenges: ensuring that member promises can be paid in full and mitigating the risks associated with climate change. The latest figures show that in the UK, 66%[1] of pension schemes are currently cashflow negative, with this figure only set to grow as more and more schemes close to future members and naturally mature.

Meanwhile, climate change has risen rapidly up the Trustee agenda, due to mounting awareness of the dangers of ignoring climate risks, as well as increased regulatory pressure. With the allocation to cashflow driven investments increasing each year, we take a look at why long-term credit investors should consider climate-related risks.

[1] Mercer 2020 Asset Allocation Survey

What are 'climate-aware' portfolios?

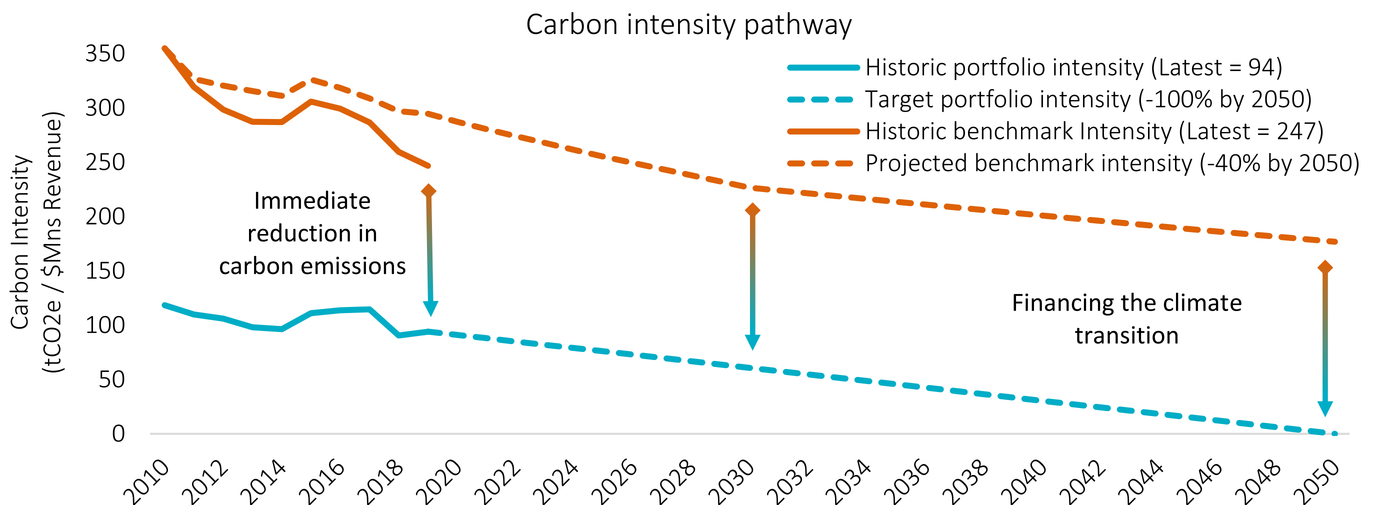
Long-term credit is commonly used as a core component in cashflow driven investment (CDI) strategies due to the high quality, liquidity, yield pick-up over government bonds and visibility of cashflows delivered by the asset class. Investors will naturally question how this component of their investment strategy will be impacted by climate change. Climate-aware investing aims to:

- Mitigate the risks to portfolios from a range of temperature scenarios
- Help limit the global temperature rise to 1.5-2.0°C above pre-industrial levels by 2100 – investors can target this through aiming for zero greenhouse gas emissions by 2050 ('Net Zero').

We believe there are two types of issuers that achieve these objectives:

- Issuers that currently have low greenhouse gas (GHG) emissions and/or positively contribute to climate change mitigation.
- Issuers that may have a high current level of emissions but have a robust and credible future decarbonisation plan. These companies are crucial to the impact goal of targeting net zero emissions by 2050.

Figure 1: Reducing emissions – the task ahead for companies and investors



Source: AXA IM. For illustrative purposes only.

Climate-aware portfolios will also have explicit climate objectives, such as reducing carbon emissions by 50% by 2030 and 100% by 2050, in line with the Institutional Investors Group on Climate Change (IIGCC) framework.

It is important to note that climate-aware investing should help, and not hinder, the overarching financial objective of schemes to pay members their benefits on time and in full.

What are the risks of climate change on credit portfolios?

Climate-related risks are emerging, of uncertain magnitude, irreversible and uneven. They present in two main forms:

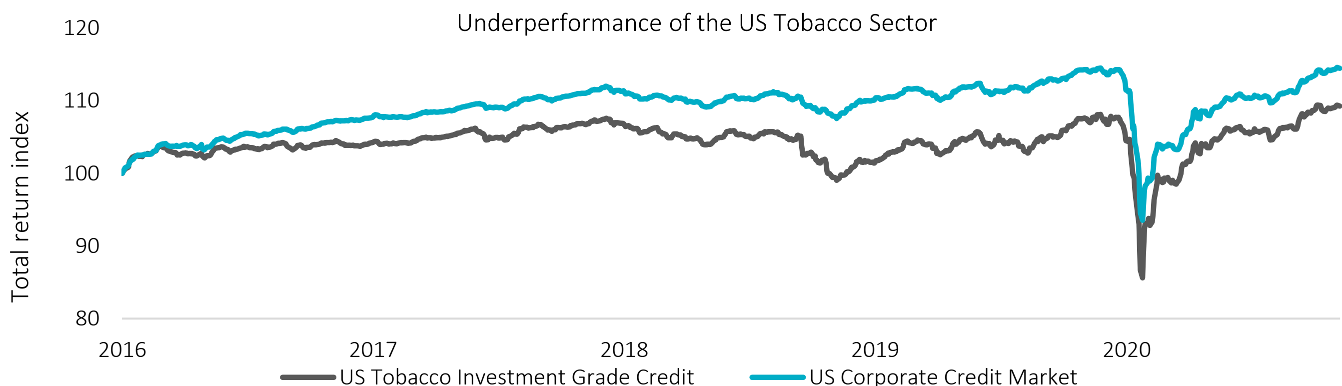
- **Physical risks** relate to the impact of climatic events if temperatures continue to rise. They might include extreme weather, such as a flood causing supply chain issues, or more chronic risks such as higher disaster insurance costs for companies.
- **Transition risks** arise from the shift to a low carbon world and include the abrupt introduction of regulation, shifts in consumer demand, technological changes and investor sentiment. For example, the ban on sale of petrol and diesel cars in the UK from 2030.

These risks could materially impact an issuer's balance sheet and access to capital markets, both of which are key inputs in credit ratings and risk analysis. It is also clear that there is enormous investor, political and regulatory momentum in climate-aware investing. This momentum alone, irrespective of how the physical risks will impact asset prices, justifies the integration of climate risk into our analysis due to the material financial impact it could have on credit portfolios.

While some energy companies have drawn intense investor pressure over what have been seen as underwhelming emissions targets, we do not see at present that a 'winners and losers' story in the climate transition is impacting spreads in the credit space. This is perhaps due to the current extraordinary global monetary stimulus, or due to the risks being underestimated by investors. However, the cost of borrowing for climate laggards could start to rise as investors fully appreciate the risks that climate change poses and shift to climate-aware strategies.

We have experienced changing investor appetite impact sectors historically. The tobacco sector, for example, which a large proportion of investors, including AXA IM, have excluded from their portfolios, has underperformed the wider index by 5% over the last five years, as the chart below shows.

Figure 2: Falling out of favour – the tobacco discount



Source: BoAML, US Investment Grade Tobacco Sector (USTO) versus the US Corporate Index (C0A0), 04/01/2016 to 04/01/2021. For illustrative purposes only.

The cost of issuing debt for US tobacco companies has changed from being 50 basis points (0.5%) cheaper than the overall corporate market in 2016 to now being 50 basis points more expensive. In the context of the current low yield environment this is an enormous change in the funding costs for these companies.

We expect the transition to the low-carbon economy to be of greater magnitude and across a larger proportion of the market and so will have a much larger impact on portfolio returns.

It will be no surprise to hear that, starting from 1 October 2021, UK pension schemes will have to evaluate how climate-related issues may impact their schemes in line with the Taskforce on Climate-related Financial Disclosures (TCFD) recommendations. In fact, we have already seen several large pension schemes and other asset owners publish and start to implement their own climate strategies. It may be that there is a 'first-mover advantage' in the climate transition with initial institutional investors best able to execute fully and cost-efficiently.

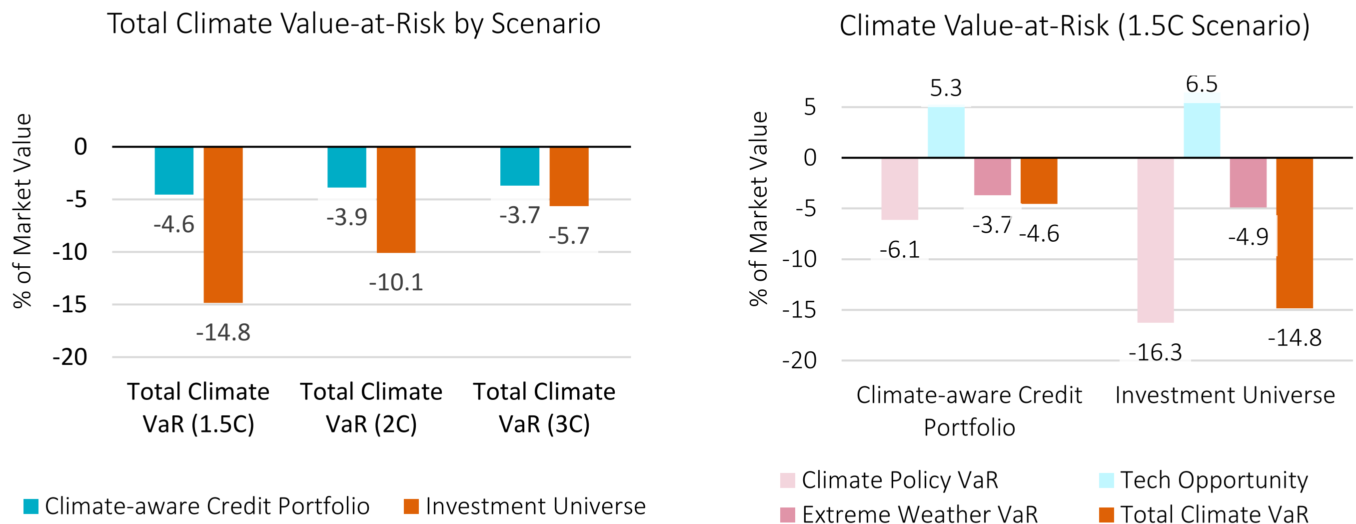
It is critical for cashflow driven investors to consider, and attempt to mitigate against, any risk that could cause volatility and a potential loss of capital.

How can a climate-aware, long-term credit portfolio mitigate against these risks?

Climate-aware investing in credit portfolios means being aware of and mitigating this emerging material risk factor, as well as targeting alignment to the 2015 Paris Agreement and fulfilling regulatory obligations. This is a magnified version of the shift in attention and assets towards environmental, social and governance (ESG) investing, both in terms of scale and importance. We view both ESG and climate-investing as a method to protect portfolios against 'tail' risks such as climate change or controversies while the fundamental ESG research undertaken by our credit analysts builds another layer of risk mitigation. Avoiding tail risks is one of the most important characteristics of a credit portfolio.

When looking at a long-term credit portfolio designed for cashflow purposes, we aim to improve the predictability of income and ultimately create resilience to market shocks in a range of market and temperature scenarios. One way to measure this resilience is by undertaking scenario analysis using climate value at risk, which measures the potential impact to a portfolio in different temperature scenarios.

Figure 2: Measuring the risk – breaking down the climate impact



Source: AXA IM. For illustrative purposes only.

We believe it is important to first reduce the magnitude of the impact of climate change compared to a traditional universe and second, to ensure that the impact on portfolios in either a 'hot' or a 'cool' scenario are not dramatically different, for the purpose of minimising the range of potential outcomes.

We also must consider how the bonds selected align with the maturity of the portfolio and fulfil the requirement to both finance climate solutions and positively allocate to rapidly decarbonising issuers. We discuss this aspect more in our next paper which focusses on how cashflow driven investors can integrate climate-awareness.

Complementing existing scheme objectives

Implementing a climate-aware strategy should not mean only investing in bonds with the lowest 'temperature' or lowest carbon emissions, irrespective of their price. On the contrary, we wholeheartedly support creating a climate strategy that complements your existing scheme objectives in terms of endgame outcomes and portfolio-level risk and return characteristics. Climate-aware investing should mitigate against the risks of a range of temperature scenarios while protecting the world in which your members will retire. Both risk-mitigation and Net Zero objectives should help schemes that are targeting either self-sufficiency or a risk transfer.

Self-sufficient schemes will want to alleviate potential shocks from physical and transition risks to maintain or improve their funding level and to avoid relying on their corporate sponsor. The long-term nature of these portfolios will have a natural alignment with the timeframe over which climate-related risks, particularly the physical risks, may emerge.

For buy-out candidates, well-designed, climate-aware strategies should be more resilient to unexpected shocks, increasing the likelihood of achieving the risk transfer.

> **"Climate change is reshaping the long-term investment landscape. The time has come to act."**

As we know from our parent company, AXA Group, many insurance companies are also rapidly integrating climate awareness into their portfolios. Schemes that implement climate-aware strategies will hold assets that are more likely to mirror those held by insurance companies, which has the benefit of more closely matching buy-out pricing and potentially reducing the cost of the transfer itself. In addition, we could see liquidity start to dry up for climate laggards meaning the time and cost of selling them increases – making it harder to transfer to a third party.

Schemes that integrate climate objectives alongside other financial objectives, should be in a better position to target their long-term goals for climate and cashflow.

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