Global Asset Management

The Carbon Conundrum

From the RBC Global Equity Team

Introduction

Asset owners, consultants and managers find themselves at the centre of the carbon conundrum, facing the need to respond to the environmental concerns of stakeholders while also maximizing returns. Conversations with asset owners and consultants have revealed a thirst for additional information regarding carbon risk. The aim of this paper is to frame the arguments around the different approaches with the aim of facilitating informed debate.

Tough Choices

The argument in favour of isolating carbon as an investment theme rests upon the strengthening consensus that burning fossil fuels contributes to global warming. Advocates of this view argue, sometimes passionately, that there is a social or political imperative to cease carbon emissions if humankind is to secure a sustainable environment. They consequently do not want to see their capital used to support businesses that add to the problem, leading them to advocate outright divestment. But even investors who take a purely financial approach are closely following the 'stranded assets' argument, which asserts that future political restrictions on the burning of fossil fuels could lead to some carbon reserves becoming too expensive to extract and therefore 'stranded'. While there are disagreements regarding the likelihood of those political restrictions, considering the potential impact of carbon restrictions on an investment case is in every investor's own interest.

Information and Scope

Even though there is agreement that carbon release has negative externalities, it is harder to quantify the amount of carbon being released. Some companies calculate and disclose the amount of carbon emitted, with some countries, like France, making this a legal obligation. In order not to penalise large businesses, carbon efficiency can then be calculated by dividing sales by units of carbon released. But there are difficulties:

- Data collection methods by firms vary and results are not audited
- Many global companies do not disclose carbon emissions, forcing investors to rely on imprecise estimates for the rest
- Data is company-specific and often excludes carbon released in the total value-chain. For example, an oven manufacturer's emissions will ignore those from the customer's use of that oven.

This last point about 'scope' raises challenges about where to define an acceptable level of carbon emission. Should we penalise just the energy generators or should distribution networks be included? What about manufacturing processes that use energy or consumers' demand for the products and services they create?

Lack of data, non-comparability of data and questions around materiality make it difficult to apply a systematic screen for each industry to exclude high carbon emitters. For example, an electric car factory may emit more carbon than a traditional one in terms of the carbon to sales ratio, but its product addresses a bigger issue.

Investment Strategies

We present two options for interested investors to consider:

	Pros	Cons
Divestment	Simple to implement Easily understood	Lose ability to influence corporate behavior Doesn't address uses of energy Restricts portfolio diversification
Engagement	Influence behavior over investment and disclosure Consistent with ESG principles of investment	Active oversight requires additional time May not satisfy the carbon activist

Divestment – excludes all fossil fuel companies

Engagement – discuss with fossil fuel producers their plans for dealing with potential restrictions on carbon emissions and their overall strategy to manage their transition to a lower carbon economy

Practical Steps

- Encourage improved corporate disclosure of carbon emissions and related strategy
- Adopt the principles of a carbon monitoring agency such as the Carbon Disclosure Project
- Engage with scheme beneficiaries to better understand their concerns
- Asset owners sensitive to carbon may consider mandating specific carbon limits for managers or implementing a carbon-aware benchmark
- Allocate capital to renewable energy solutions
- Implement ESG investment principles to fully understand and manage carbon-related risks.

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