Ninety One

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Previously Investec Asset Management

Investing to tackle climate risk

March 2019

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Contents

About Ninety One

Ninety One is a specialist investment manager, providing a premier range of products to institutional and individual investors. Employees are equity stakeholders in the firm. Established in 1991, the firm has been built from a small start-up into an international business managing US$133.7 billion* on behalf of third party clients.

We have grown from domestic roots in Southern Africa and the UK to a position where we proudly serve a growing international client base from the Americas, Europe, Asia, Australia, the Middle East and Africa.

We employ 238 investment professionals. The firm seeks to create a profitable partnership between clients, shareholders and employees, and to exceed clients' performance and service expectations.

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*Source: Ninety One, 31.12.18. Numbers are unaudited and updated quarterly.

> Right now, we are facing a man-made disaster of global scale. If we don't take action, the collapse of our civilisations and the extinction of much of the natural world is on the horizon

Sir David Attenborough

Right now, we
of global scal
collapse of ou

Executive summary

Two years ago, Mark Carney and Michael Bloomberg argued that investors didn't have the information they need to respond to rising risks of climate change. Now, it is a different story.

In the race to prevent irrevocable damage to our planet, pension funds have an opportunity to tackle climate risk head-on. The UK's Department of Work and Pensions (DWP) also requires pension schemes to explain to their members how they're accounting for climate risk.

For pension schemes, whose role is to allocate capital to manage risks and seek opportunities to protect people's financial future, this poses an unnerving question – are we doing enough?

Physical risks such as severe storms, droughts, floods, wild fires and melting ice caps that increasingly fill our screens are beginning to impact the way we think about asset valuations.

Regulation, changing consumer preferences, disruptive technology and liability from non-action are now critical transition risks to consider as the stakes have never been higher.

For many institutional investors assessing climate risk, measuring carbon emissions has been the first step. This approach has been largely limited to what is called 'Scope 1' and 'Scope 2' carbon emissions – namely direct and indirect emissions of the company like those from purchased electricity.

A full risk assessment requires Scope 3

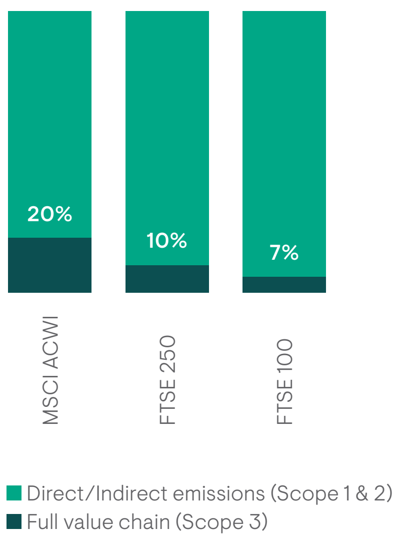
'Scope 3' carbon emissions are key. They cover the entire corporate value chain including those generated by their products after point of sale.

Measuring the extent of carbon emissions across this full value and supply chain is challenging from a data accuracy and consistency perspective. But it is far more comprehensive. It is estimated that over 90% of the carbon emissions attributable to the FTSE 100 or FTSE 250 are in fact 'Scope 3' which therefore suggests that levels of climate risk are being massively underestimated in asset owner portfolios.

Invest to reduce climate risk

With more systemic climate risk in portfolios than initially thought, how can asset owners respond? Rather than focusing on divestment, we believe that investing positively in companies reducing carbon emissions and enabling transition to a de-carbonised growth model offers the best opportunity to improve the level of protection from climate risk in your portfolio.

Emissions breakdown for major indices



Source: IAM, Engaged Tracking. December 2018.

> The challenges currently posed by climate changes pale in significance compared with what might come... The more we invest with foresight; the less we will regret in hindsight

Mark Carney

We have defined the Ninety One Global Environment universe using a proprietary model which actively reduces carbon emissions and includes companies that benefit from the structural growth areas of a de-carbonising economy. What is striking is that this universe has little or no overlap with traditional equity allocations such as the MSCI All Country World Index or the FTSE 100.

Investment in this universe can offer three complementary benefits:

1. Invest in companies that should enjoy a tailwind of structural growth. Renewables will likely grow to 80% plus of the power generation mix by 2050.

2. Correct structural under-exposure to the enablers and beneficiaries of decarbonisation. These companies sit across a wide range of sectors and geographies. It is a complex and emerging structural growth area, which is often misunderstood and requires a specialist allocation.

3. Provide a hedge against systemic exposure to carbon which exists in current portfolios. An allocation to companies delivering a positive environmental outcome will go some way to insuring the inherent and often underestimated carbon risk in portfolios.

Twelve years to get on track

Central bankers and world-famous naturalists may not be common bedfellows, but the alignment in thinking of Mark Carney and Sir David Attenborough symbolises the relationship between climate and financial risks.

In October 2018, the world's leading climate scientists warned there are only a dozen years for global warming to be kept to a maximum of 1.5°C above pre-industrial levels. Just half a degree above that will significantly worsen the risks of drought, floods, extreme heat and poverty for hundreds of millions of people.

At the same time, asset owners are becoming increasingly aware of climate risk. Krueger and Starks, two academics, recently showed that 80% of institutional investors, representing trillions of assets, thought that climate risks have already begun to materialise, with financial implications for their portfolio firms. Although, according to the Asset Owners Disclosure Project (AODP), more than 60% of the world's largest pension funds have made little progress on reporting the financial implications of climate change.

As of October 2019, the Department of Work and Pensions (DWP) require all trust-based pension schemes to update their statement of investment principles to include risks associated with climate change, the transition to a low-carbon economy and wider ESG issues. Schemes will then be required to report annually on actions taken to address ESG risk factors.

Climate scientists warned there are only a dozen years for global warming to be kept to a maximum of 1.5°C above pre-industrial levels

Published climate risk guidance

Asset owners today have a tailor-made framework for assessing climate risk impact on their portfolios.

In 2017, the Task Force for Climate Related Disclosures (TCFD), an initiative by the Financial Stability Board, published a ground-breaking framework for asset owners to assess and address climate risk.

Asset owners today have a tailor-made framework for assessing climate risk impact on their portfolios

This helps companies understand the disclosure required by financial markets to measure and respond to climate change risks and encourages firms to align their disclosures with investors' needs. It sets[1] out the risks that organisations should address under two categories – transition and physical risks – and their financial implications:

Transition risks (to a decarbonised future)

The economic and energy transition to a decarbonised future will have a direct and significant impact on asset owners' portfolios. Major themes include the rapid energy transition to renewable sources and the adoption rates of electric vehicles.

These transition risks are gaining clarity as each country moves to address climate change. More specifically, the risks come from policy and regulatory change and any shocks created as stakeholders address climate change. Transition risks also include changing consumer preferences or shifts in technology that can replace goods or services with lower emissions.

Physical (climate) risks

Failure to consider the risks and opportunities from the energy transition may have a severe impact on future wealth, the consistency of income received from portfolios and the ability to meet long-term liabilities.

The Bank of England adds litigation risk as a third category of climate risk anticipating that companies who are irresponsible with their carbon emissions could face lawsuits in the future.

1. https://www.tcfdhub.org/Downloads/pdfs/E08%20-%20Table%201%20&%202.pdf

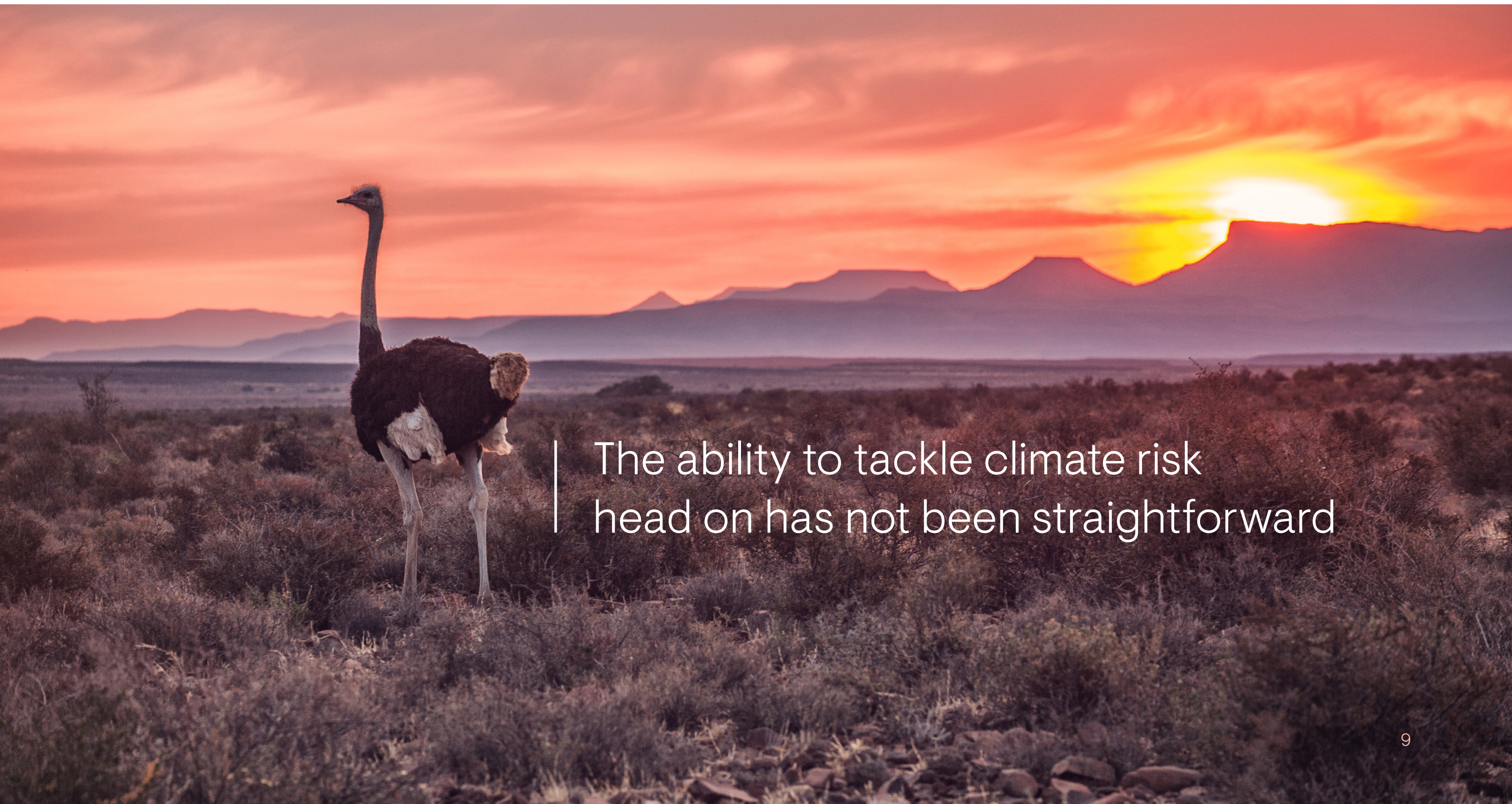
The hurdles are diminishing

The ability to tackle climate risk head on has not been straight forward. Various hurdles have hampered the speed of integration. These have included debate on the extent of climate risk within a portfolio, a lack of regulatory pressure and a dearth of consistent company level reporting on climate risk and specifically carbon emissions.

Progress has been made. Few deny the effects of climate change and the risks it poses to asset valuations, regulation is moving front and centre globally and, we have seen steps forward in the quality, standards and consistency of carbon emissions data.

Understanding how to report carbon emissions has been one of the more contentious issues confronting investors and pension schemes. Still much progress to be made, but with access to better data, a more effective assessment of climate risk and investment opportunities can be actioned. Better data also facilitates decisive action that could deliver beneficial financial and environmental outcomes. Asset managers have needed to do a better job in profiling and measuring carbon emissions at a portfolio and fund level.

The vast improvements in our ability to harness expanding amounts of data is helping transform our understanding of climate risk and the types of solutions pension schemes can invest in. It also suggests many efforts so far to account for climate risk are underestimating the extent of the problem.



> The ability to tackle climate risk head on has not been straightforward

Much more climate risk than previously considered

Many decisions to exclude large carbon emitters from a portfolio will be based on a company's direct and indirect carbon emissions and do not account for the carbon emissions generated by the entire corporate value chain including those of the company's products after they are sold.

The Greenhouse Gas Protocol (GHG Protocol), is the internationally accepted standard to measure and manage GHG emissions. ESG or low-carbon screens will typically consider Scope 1 and Scope 2 carbon emissions, but in fact the protocol defines three carbon emission categories.

Scope 3 measures carbon emissions over the entire corporate value chain including those created by the products they have sold. Historically measuring Scope 3 carbon has been difficult and inconsistent but as progress is made, the need to include Scope 3 when integrating climate risk at a portfolio level is becoming clear.

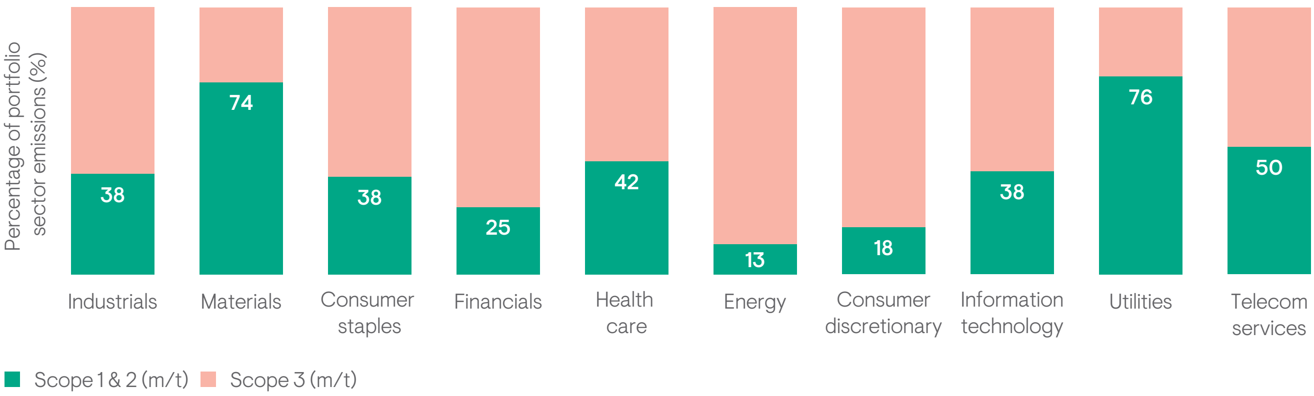
The Association of Chartered Certified Accountants has estimated that about 75% of any company's carbon emissions sit within Scope 3. This is particularly important for the extractive industries (such as mining and oil) that form, for example, a large part of the FTSE 100. Figure 1 indicates the extent to which global equity sectors break down the different categories of carbon emissions.

Mining coal or drilling for oil is not particularly carbon intensive but burning coal in power plants or driving a car propelled by an internal combustion engine are. Hence the direct (Scope 1 & 2) carbon footprint of the FTSE 100, which is overweight energy and miners but underweight utilities relative to other global markets, is lower than global peers. The FTSE 100 has a carbon intensity (defined as tonnes of carbon per $million of revenue) of 142 versus 195 for the S&P 500.

This may lead to UK institutions significantly underestimating their climate risk. In fact, Engaged Tracking, which ranks companies by Scope 1, 2 and 3 emissions, estimates that 97% of the carbon footprint of the FTSE100, and 94% of the FTSE 250 is Scope 3 carbon.

This leads us to conclude that, while the FTSE 100 is carbon intensive on a Scope 3 basis, it is also remarkably underweight those companies whose products and services are contributing to the energy transition – which we have defined using our proprietary model as the Ninety One Global Environment universe.

Figure 1: Carbon emissions per sector – Global Equities



Source: PRI, May 2015. Illustrative portfolio created and measured by South Pole Carbon.

Figure 2: GHG Protocol – carbon emission categories

Scope 1 Direct	Company facilities	Company vehicles	Scope 1 carbon emissions are the direct emissions from owned or controlled sources - Fuel burned on site - Owned vehicles
Scope 2 Indirect	Purchased electricity, steam, heating and cooling for own use		Scope 2 carbon emissions are the indirect emissions from the generation of purchased energy
Scope 3 Indirect	Purchased goods and services Processing and sold products Upstream leased assets Capital goods Use of sold products End-of-life treatment of sold products Fuel and energy-related activities Waste generated in operations Downstream leased assets	Upstream transport and distribution Business travel Franchises Downstream transport and distribution Employee commuting Investments	There are 15 separate categories of Scope 3 including: - 8 relating to the supply chain - 7 relating to the emissions of the products once they are sold/used

Carbon risk

Source Figure 2: Ninety One, Engaged Tracking (ET) Index Research, GHG Protocol, November 2018.

Case study: The ultimate blue chip?

In 2018, asset owners witnessed a textbook example of why monitoring only Scope 1 and 2 carbon and investing in first generation low-carbon products will not avoid climate risk.

General Electric was subject to intense pressure on its power generation business from the energy transition to renewables. The problem was exacerbated by GE's $10.5bn acquisition in November 2015 of Alstom's power generation business, which was predominantly focused on coal generation. Just three years later, GE wrote off $23bn of goodwill in its power generation business related to a large extent to the Alstom acquisition.

From a Scope 1 and 2 perspective, GE is not a particularly carbon-intensive business. GE reports carbon intensity of about 32 t CO_2e per $million of revenue.

All its emissions sit in Scope 3, in this case, with its customers, one of the largest being the Southern Company which reports carbon intensity of about 32,192 mt per $ revenue. The latter is one of the dirtiest companies in the S&P 500 but, as a regulated monopoly utility, the Southern Company was much better placed to manage the energy transition than its supplier.

Had GE included Scope 3 emissions, we estimate that its carbon intensity would increase from 32 to 49442 mt CO_2e per $mm revenue, which would have put the company right at the top of the pile in terms of potential climate risk.

> This may lead to UK institutions significantly underestimating their climate risk

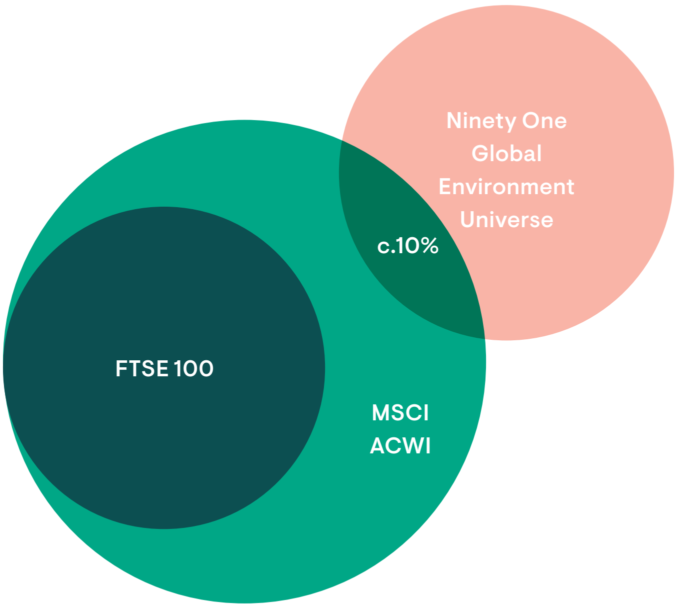
Invest positively to hedge against climate change

A significant amount of the discussion around climate risk revolves around divestment. However, in many cases these strategies don't provide sufficient protection from climate risk nor can they provide an offset to climate risk by benefitting from a decarbonising growth model.

As Mark Carney points out, understanding climate risk correctly is only the first part of the problem. The next step is to invest in the solutions that will support the energy transition and decarbonise the global economy.

When climate scientists warn of impending disaster from inaction, they also highlight positive investment solutions. They require, according to Jim Skea, co-chair of the working group on mitigation for the IPCC, "an unprecedented shift in energy systems and transport". Many of the companies behind the solutions are in renewables and transportation, where rapidly improving technology and lower costs are creating structural growth opportunities for 20 to 30 years. More broadly, the companies most exposed to the energy transition sit across a wide range of sectors and geographies, often with smaller market capitalisations but higher than average growth rates.

Figure 3:
Very little overlap between a positive environment strategy and traditional equity universes



Source: MSCI, Ninety One. Not to scale.

With more systemic climate risk in portfolios than initially thought, a decisive move to tackle climate change and support a successful transition requires a dedicated positive investment to offset this risk. The Ninety One Global Environment universe is designed for this purpose using a proprietary model which actively reduces carbon emissions. The universe includes companies that benefit from the structural growth areas of a decarbonising economy.

> The next step is to invest in the solutions that will support the energy transition and decarbonise the global economy

When comparing to traditional equity universes, what is striking is that the Global Environment universe has little or no overlap with traditional equity allocations such as the MSCI All Country World Index or the FTSE 100 (Figure 3). Furthermore, the universe has no exposure to the 100 companies identified as the world's largest carbon emitters by Climate Action 100. This is not the case with a number of low-carbon equity products which hold as many as 62 of these companies (Figure 4).

Figure 4:
Exposure to companies identified as 100 largest carbon emitters by Climate Action 100+

	Number of companies held	Weight %
SPDR® MSCI ACWI Low Carbon	41	7.26%
Amundi IS Equity Global Low Carbon	39	7.03%
Ishares MSCI ACWI Low Carbon	37	6.78%
L&G Future World Climate Change Equity	62	9.50%
Ninety One Global Environment Universe	0	0%

Source: Morningstar, Climate Action 100+, Ninety One.

For those pension funds that have taken initial steps to manage climate risk across their portfolios, a positive allocation to companies facilitating the energy transition provide a complementary investment. An investment that better protects against climate risk. Figure 5 outlines the relative effectiveness of different climate-related solutions.

> A positive allocation to companies facilitating the energy transition provides a complementary investment

Figure 5:
Pension fund climate-related investments and their impact on your portfolio

	Offsets transition risk	Reduces carbon footprint	Benefits from structural growth of decarbonisation
Green Infrastructure (Private Markets)	oo	oo	o
Green Bonds	o	o	o
ESG filter or Low carbon screen – Equity allocations	o	o	x
Dedicated allocation to the Ninety One Global Environment Universe	ooo	ooo	ooo

Source: Ninety One. See Appendix 1 for details related to the scoring.

Finding the companies that benefit from decarbonisation

Constructing the Ninety One Global Environment universe is an intricate task, reflecting the complexity of the climate challenge. The global industry classification standard (GICS) does not include an 'environmental' sector. Our proprietary screening methodology allows us to screen companies that earn at least 50% of their revenues in areas that are impacted by the energy transition to renewable energy. We have worked with Engaged Tracking, which is a leading provider of carbon data, to carefully calculate whether the products and services of these companies are more carbon efficient than the alternative.

The ultimate universe consists of more than 700 companies with a total market cap of over US $6.5 trillion, distributed between the US, China and the rest of the world. **The universe does not include any companies from the FTSE 100.**

Figure 6: Ninety One Global Environment Universe definition

Global equities with market cap

>US $500m

Energy transition

2000 companies in sectors exposed to energy transition

Gross carbon avoided

700 companies with quantified carbon avoided

From a sector perspective, the companies whose revenues will benefit from decarbonisation sit within industrials, utilities, energy, technology, materials, chemicals and automotive sectors, or across almost 60% of the GICS. Just less than half the companies have market capitalisations under US $1 billion, and almost one third of them are in China. The Ninety One Global Environment universe has the following characteristics:

Figure 7: Ninety One Global Environment Universe characteristics

- Consumer discretionary, 100
- Consumer staples, 3
- Energy, 5
- Industrials, 262
- Information technology, 127
- Materials, 129
- Real estate, 2
- Utilities, 163

- China, 224
- Europe, 158
- United States, 129
- Japan, 84
- Other, 196

- Large cap (>$10bn), 137
- Mid cap ($2bn - $10bn), 289
- Small cap (<$2bn), 365

Source Figure 6: Ninety One, February 2019.
For further information on indices and investment process, please see the Important information section.

Pension funds can take decisive action

Equity allocations to the UK and to global equity portfolios in many cases will under represent decarbonisation, mostly because the companies within the Global Environment universe are growing much faster than the global economy and equity markets as a whole due to their exposure to the energy transition. The environment universe of companies currently has trailing revenue growth of around 20% per annum.

A direct investment in this Global Environment universe provides the opportunity to meaningfully adapt your portfolio to climate risk with the following benefits:

1. Invests in companies that should enjoy a tailwind of structural growth, which will drive higher revenues, margins and profitability. For example, within the renewable energy sector, solar and wind have grown from 0.2% of the world's power generation mix in 2000 to 7% in 2017. Renewables will likely grow to 80% plus of the power generation mix by 2050.
2. Addresses structural underexposure to the enablers and beneficiaries of decarbonisation. These companies sit across a wide range of sectors and geographies. Many are smaller in market capitalisation but with much higher-than-average growth rates: it is a complex and emerging structural growth area, which is often misunderstood and requires a specialist allocation.
3. Provides a hedge for asset owners who need to offset the systemic exposure to carbon which is likely underestimated in current portfolios. An allocation to companies delivering a positive environmental outcome will go some way to hedging the inherent carbon risk in portfolios.

Investing with foresight in companies that are benefitting from decarbonisation and the energy transition can help asset owners hedge some of the systemic carbon risk that exists mostly unacknowledged in their portfolios. It can also save pension scheme trustees from regretting with hindsight.

Appendix 1

Scoring for climate-related investments and their impact on your portfolio

In Figure 5, we display a series of scores showing the relative effectiveness of different climate-related solutions that may have been implemented within your portfolio. Three categories are considered:

- Transition risk
- Reduction in carbon emissions
- Positive investment in those companies driving and benefiting from the decarbonising economy.

We apply these categories to four different types of investment solutions. It is acknowledged that the variation within the assets of these types of solutions could lead to different scoring, therefore the scores provided in Figure 5 offer a guide based on the following settings:

Offsets transition risk

x No integration of transition risk
o Screens some investments where valuations are threatened by transition risk
oo Can provide a one-off investment that contributes to mitigating transition risk
ooo Actively invests in companies that lower transition risk

Reduces carbon footprint

x No reduction in carbon footprint
o Screens high emitters using Scope 1 and Scope 2 level reporting
oo Incorporates a set level of carbon avoided (e.g. funding renewable infrastructure)
ooo Screens companies using Scope 3 and actively invests in carbon avoided

Benefits from structural growth of decarbonisation

x No benefit
o Potential for improved valuations should decarbonisation move faster (e.g. spread on green bond tightens)
oo Combines one-off investments with exposure to developers that benefit if decarbonisation moves faster
ooo Actively invests in companies set to benefit from the structural growth trends from a decarbonising economy

Figure 5: Pension fund climate related investments and their impact on your portfolio (repeated for ease of reference)

	Offsets transition risk	Reduces carbon footprint	Benefits from structural growth of decarbonisation
Green Infrastructure (Private Markets)	oo	oo	o
Green Bonds	o	o	o
ESG filter or Low carbon screen – Equity allocations	o	o	x
Dedicated allocation to the Ninety One Global Environment Universe	ooo	ooo	ooo

General risks:

Value of investments, and any income generated from them, can fall as well as rise. Past performance is not a reliable indicator of future results. Investment objectives and performance targets may not necessarily be achieved, losses may be made. Commodity prices can be extremely volatile and significant losses may be made.

Specific risks:

Commodity-related investment: Commodity prices can be extremely volatile and significant losses may be made. Concentrated portfolio: The portfolio invests in a relatively small number of individual holdings. This may mean wider fluctuations in value than more broadly invested portfolios. Currency exchange: Changes in the relative values of different currencies may adversely affect the value of investments and any related income. Derivatives: The use of derivatives is not intended to increase the overall level of risk. However, the use of derivatives may still lead to large changes in value and includes the potential for large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. Emerging market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. Equity investment: The value of equities (e.g. shares) and equity-related investments may vary according to company profits and futur e prospects as well as more general market factors. In the event of a company default (e.g. insolvency), the owners of their equity rank last in terms of any financial payment from that company. Geographic/Sector: investments may be primarily concentrated in specific countries, geographical regions and/or industry sectors. This may mean that the resulting value may decrease whilst portfolios more broadly invested might grow.

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