RESPONSIBLE INVESTMENT QUARTERLY

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COLUMBIA THREADNEEDLE INVESTMENTS

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Stewardship in action

01 Foreword

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The third quarter is normally a quieter period following the main corporate Annual General Meeting season and, this year, being the final run-up to the COP26 conference in Glasgow.

With COP26 a key milestone for the global climate response, climate issues remain a key focus. In this report we begin by looking at the main outcomes from the conference and what they might mean for us as stewards of capital.

Taking stock after the proxy voting season, we saw more active use of voting rights by shareholders, not least on environmental issues, with the oil and gas industry a particular focus. In the US, proposals seeking disclosure of climate transition plans and the adoption of an advisory climate vote saw the average levels of support approaching 45%, while those dealing with climate lobbying saw average support of around 51%.

Some notably markers were put down, with proposals seeking emissions reduction targets at Chevron, Phillips 66 and ConocoPhillips gaining majority support. Perhaps more telling, however, was the success of hedge fund Engine No.1 which won three of four board seats at Exxon after a campaign based on the oil major's failure to establish robust climate transition targets and fund low-carbon sources of energy.

Although shareholder proposals are a more common element of the US market, Europe saw the number of environmental shareholder proposals (20) rise again for the fourth year in a row, although the levels of support were lower, averaging just below 18%. In Asia, despite a higher number of proposals than Europe (more than 30) the average level of support was running at a lower 14%.

We also look at carbon pricing, which is a critical policy tool to promote decarbonisation and achieve CO_2 emission reductions in line with the goals of the Paris Agreement on climate change. Net zero is

We have seen more active use of voting rights by shareholders.

Source: iStock.

going to impact all companies, in all industries, and we look at the role of carbon pricing, the range of global carbon pricing schemes and the considerations for analysts, portfolio managers and advisors about the potential impacts of carbon pricing.

While climate remains a dominant theme in the debate, not all issues investors need to consider are environmental. This quarter we also discuss some of our work and focus on social issues and the implications of related controversies. With the UN Human Rights Council working on its third draft of a Treaty on Business and Human Rights (BHR), the importance of this focus is set to become more significant as the Treaty could well increase corporate legal liability where human rights abuse occur in their global supply chains.

The case studies included highlight the challenges surrounding corporate controversies and anticipating regulatory change in the field of human rights. They also emphasise the risks and opportunities associated with them.

These insights are intended to help frame the type of research intensity and thinking involved in ensuring investment approaches and decisions are well informed. As one commentator recently noted: "A blanket statement 'ESG always pays off' is as misleading as saying 'Food is good for you' – it depends on the type of food."

First there needs to be a focus on issues that are material. Secondly there needs to be a focus on understanding the potential risks and opportunities. Third, there needs to be a focus on valuations and what is or isn't priced in. In an investment context, good ESG research isn't a stand-alone focus, it has to be an integral part of fundamental research.

While there is often an overwhelming focus in the ESG debate on what is topical, those things will not necessarily be the most important issues in many cases and, often, once you account for exposure to standard – for example, style or sector – factors and tilts, the performance of more dogmatic ESG approaches can become challenged.

Exploring this further, part of the argument for regulatory changes and the implicit effort to shift the flow of capital in the public markets is that it helps reduce the cost of "good" companies' capital. In practice, that creates a dichotomy for investors, which also underlines the importance of ESG research being part of fundamental research.

What has been recognisable for a while is a herding effect around ESG favourites, inflating share prices. This dynamic is not new and was, for example, already being written and studied by analysts at Goldman Sachs in 2019[1] who found that the most-overweight ESG favourites were trading at substantial premiums to the market, of as much as 40% on both earnings and earnings before interest, taxes, depreciation, and amortisation (EBITDA).

The resulting bubble in a share price may provide a short-term appearance of a company's outperformance but, if as intended in the cost-of-capital argument, that compresses the return or yield of the investment, this dynamic creates something of a dichotomy for investors. Successfully reducing a company's cost of capital will mean lower returns for investors. This highlights the need for, and importance of, research intensity that is grounded in fundamentals and helps identify sound investment opportunities in what is a rapidly changing world.

It is important to recognise that the ideal company, for example those involved in the EU's Green Taxonomy compliant activities, may not make for the ideal investment. Given their scarcity, the herding issues may also prove to be a particular problem.

In contrast, the commonly cited case of the Danish multinational company Orsted offers an alternative opportunity. The active user of coal fired power stations set a target of ending its use of coal in its power stations by 2023.[2] Since then the company has become the world's largest developer of offshore wind power and its value has increased more than 4.5x from the beginning of 2017 to its peak earlier this year.[3] Those investors that saw the potential of the company's strategic transformation have been richly rewarded over this time.

Set against this context we hope the insights offered in this report help support an understanding of the thinking and approaches that are integral to effective responsible investment and in turn help inform and focus our active ownership priorities.

Source:
1 Goldman Sachs, Is there an emerging 'ESG Nifty Fifty'?", September 2019.
2 https://orsted.com/en/sustainability#cat0&tile4
3 Bloomberg, October 2021.


THERE IS
NO PLANET
B

02 COP26 summary: a meaningful result

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From 31 October – 13 November world leaders and their delegations from nearly all countries across the globe came together to work on the issue of climate change. We look at what was achieved over the course of the conference:[1]

Major takeaways:

- **The ratchet mechanism works:** temperature alignment will continue to be wound down towards 1.5 degrees centigrade over subsequent cycles of negotiations – this is a clear indication of the direction of future policy
- **The private sector has stepped up:** when including all pledges – net-zero targets and other commitments not currently incorporated in policy – they add up to an end result of 1.8 degrees
- **Carbon markets:** rules on international carbon trading have been established. Loopholes remain so caution is needed
- **Civil society is unconvinced:** despite COP26 yielding better results than anyone on the inside expected, protestors and civil society have reacted negatively. Pressure to achieve 1.5 degrees has, if anything, increased. Attention to pledges and especially net-zero commitments will be strong. Companies will face reputational risk if they try to fudge net-zero pledges.

The last-minute games played by the Indian and Chinese delegations got the headlines, but the biggest result to emerge from this COP (Conference of the Parties) was confirmation that the ratchet mechanism designed under Paris 2015 agreement works – this was its first test and it passed. National pledges wound projected temperatures down by 0.3 degrees and, what is more, those pledges will need to be updated by next year's COP, accelerating the ratchet mechanism that would normally run on a five-year cycle.

Going into the summit the goal was to keep the target of 1.5 degrees alive, and this ratchet acceleration has done that. No one expected to be able to get national pledges (known as nationally determined contributions or NDCs) down to 1.5 degrees on a single cycle, so accelerating the next cycle is a meaningful result.

One overarching takeaway is how the focus of these meetings has changed – from 2 degrees and timelines of 2050 to 1.5 degrees and 2030. This aligns the political discussions with the science which shows that a 45% decline in emissions is required, based on 2010 levels, by 2030 in order to limit temperature rise to 1.5 degrees (based on 2019 levels this increases to a 50% decline). Figure 1 shows the alignment of temperatures against various tiers of pledges.

Figure 1: alignment of pledges

Temperature rise (degrees centigrade)	
1.8	If all NDCs, pledges and net-zero targets and corporate pledges agreed at COP26 are achieved (optimistic scenario)
2.1	NDCs plus the US and China net-zero targets
2.4	NDCs submitted at Paris 2015 only
2.7	Current policy (does not include policy proposals)

130 countries promised to collectively halt and reverse forest loss.

The private sector took on more of a role than ever before at this year's COP, with corporate commitments on a number of topics. These are summarised here:

- **Deforestation:** 130 countries promised to collectively halt and reverse forest loss and land degradation by 2030. Countries representing 85% of global forests, including Brazil, Indonesia and the Democratic Republic of Congo (DRC), backed this commitment but scepticism remains around whether it will be delivered. $12 billion in public funds for forests, and more than $7 billion in public-private investments have been committed towards this. Thirty financial institutions with more than $8.7 trillion of global assets committed to eliminate investment in activities linked to deforestation.
- **Methane:** led by the US and the EU, 109 countries committed to reducing methane emissions by 30% before 2030, including Indonesia, Canada, Brazil, UK, Bahrain, Uruguay, Cuba and Malaysia. China has committed to continue the discussion with the US in the first half of 2022 to focus on the specifics of enhancing measurement and mitigation of methane. Russia is a notable absence.
- **Internal Combustion Engines:** a group of companies and countries are working towards 100% electric vehicle sales by 2035 in leading markets and 2040 in developing markets. Members include the UK, Canada, Norway, Chile, India and Kenya, along with Ford, General Motors, Jaguar Land Rover , Mercedes-Benz and Volvo.
- **Innovation:** COP26 saw multiple announcements on innovation in hard-to-abate sectors such as cement, steel and green hydrogen. Some of these are focused on stimulating demand rather than supply, which in turn should encourage existing producers to innovate and increase supply – "if you make it, we will buy it".
- **Oil and gas:** the attention is broadening beyond coal, and new initiatives are targeting the supply side as well as demand.
- **Coal:** underwhelming agreements outside of South Africa's "just transition" partnership, but the economics are starting to win this battle. For example, even under Donald Trump the US retired the most coal globally and installed the second highest capacity volumes of renewable energy globally

after China. The South African mechanism provides a framework to move other coal dependent nations beyond the fuel.

- **Asset management aiming for net zero:** the Glasgow Financial Alliance for Net Zero announced that firms with a combined $130 trillion owned or managed have committed to net zero (through the Net Zero Asset Managers commitment, Net Zero Asset Owners and similar pledges covering nearly every corner of the financial services industry). This figure includes a large amount of double-counting and has been widely misinterpreted. Nonetheless, it is a huge share of the world's largest financial institutions committing to net zero – Columbia Threadneedle Investments' AUM is included in this figure as a signatory of the Net Zero Asset Managers Initiative.

Methane pledge – buying time

Relative to CO_2, methane has 84x as much global warming potential over a 20-year time horizon. Cutting methane rapidly, therefore, gives the world slightly more wiggle room on carbon. This is desperately needed as the latest science outlines that the world has only eight more years of emissions at 2019 levels to go before a 1.5 degree carbon budget is exceeded.

The methane pledge aims for a 30% reduction by 2030; however, the International Energy Agency (IEA) estimates that methane emissions need to fall by 75% to meet net zero.[2] Canada has committed to this punchy target in the oil and gas sector which, along with agriculture, are responsible for the lion's share of global methane emissions. More than 50% of methane emissions in the oil and gas sector can be resolved today with current technology, while satellite data is improving the extent to which these emissions can be independently tracked.

Article 6 and carbon trading

The rulebook around carbon trading was finalised at COP26 and part of this is relevant to corporate carbon offsetting. These rules still have a number of loopholes so scrutiny is likely to remain high. We will keep an eye on the type of carbon credits bought by the companies we own – especially those held in responsible investment funds.

Carry over of low-quality credits: while the carry-over of older, less-credible permits from the Kyoto protocol (called CERs) will be allowed, the situation could have been worse. Out of a potential four billion CER credits, only 320 million will be carried forward and these will be clearly labelled and easy to avoid. However, a bigger concern is that governments could authorise projects to continue to issue credits (equivalent to CERs but generated from 2021-2030); but as most of these projects are wind or hydro-related they will at least produce clean energy, and hence avoid emissions and generate credits, whether or not they are eligible under Article 6 and do not provide "additionality". If all governments authorise all eligible projects to transition into the new system under Article 6, it is estimated 2.8 billion carbon credits of a very low quality would enter the system.

Double counting is (almost) out: Before COP26, Brazil had been arguing for the ability to double-count carbon credits. What they were suggesting, to use a hypothetical example, was that a carbon credit equivalent to a tonne of carbon dioxide generated by a forestry project in Brazil and sold to the UK would count towards both Brazil's and the UK's NDC, reducing both by one tonne. Brazil stepped away from this position at COP26, enabling a conclusion, and it was agreed that seller countries must account for all units that are transferred to other countries, preventing the possibility of double counting.

However, under the carbon trading mechanism, as opposed to bilateral trading, there is an option for countries to issue non-authorised credits for "other international mitigation purposes", ie voluntary carbon markets which would not be subject to the carbon accounting adjustments to eliminate double counting. There was heavy debate around how this class of credit should be used and how much it contributes to corporate greenwashing, with countries such as Switzerland calling for stronger rules. Ultimately, companies using authorised credits towards their net-zero targets will be seen as more credible than those using non-authorised credits. It will be interesting to see if carbon credit pricing deviates according to quality once this mechanism is fully established, with a small number of carbon credit rating agencies already in existence.

Voluntary retirement of carbon credits: it was agreed that bilateral carbon trades between countries for use in NDCs will only need to retire credits on a voluntary basis. This is weaker than hoped as cancellation of a portion of emissions would mean more than one tonne of carbon credits would be required to offset one tonne of

actual emissions – meaning an overall net emission reduction. However, the carbon trading mechanism covered in another area of Article 6, and the area most relevant to the private sector, will be subject to a mandatory retirement of 2%. Another rule impacting the trading mechanism, but not bilateral trades, is that 5% of proceeds from trades under the mechanism must be transferred to an Adaptation fund to finance adaptation or resilience projects in the countries already most vulnerable to climate change.

Innovation in hard-to-abate sectors – The Glasgow Breakthrough Agenda

- **Hydrogen:** the World Business Council for Sustainable Development (WBCSD) and the Sustainable Markets Initiative (SMI) announced pledges of 28 companies to drive growth in the demand for, and supply of, hydrogen. This can be in four categories: supply, demand, financial support or technological support. On the demand side pledges add up to 1.6 million tons per annum (mtpa) of low-carbon hydrogen to replace grey hydrogen which is currently used in the chemical industry and refining. On the supply side the pledges add up to 18 mtpa of low-carbon hydrogen. In emissions terms this would save the equivalent of the annual emissions of Netherlands and Tunisia combined. Also, African and Latin American green hydrogen alliances are aiming to accelerate green hydrogen adoption in those areas. Namibia has already made progress with the Dutch, Belgian and German governments, with Germany committing to provide €40 million.
- **Steel and cement:** The UK and India led the Industrial Deep Decarbonisation Initiative (IDDI), alongside Canada and Germany, which aims to drive demand for "green" steel and green cement which will in turn accelerate supply. Currently, cement and steel each account for around 7% of energy-related emissions globally but do not have easy decarbonisation options. This is because the high temperatures required are harder (but not impossible) to achieve via electricity rather than fossil fuel energy. The most common process of steelmaking also uses coal as a reagent, although it is possible to use hydrogen. The initiative will work to set criteria for green cement and steel, encourage greater transparency and traceability and look to set a globally recognised target for public procurement of green steel and cement. Member governments also committed to the disclosure of embodied carbon of major public construction by no later than 2025.[3]
- **Steel, trucking, shipping, aviation, cement, aluminium, chemicals and direct air capture:** The first movers coalition is a US-led coalition of corporates to stimulate clean tech demand for hard-to-decarbonise areas which will in turn incentivise supply. Its statement said: "Members will use their global purchasing power to create new markets for these emerging technologies. These new demand signals empower suppliers to develop and scale their innovations between now and 2030 – helping us to reach our global emission targets.".[4]
- **Shipping:** there were three announcements/initiatives of note. More than 200 businesses have committed to scale and commercialise zero-emissions shipping vessels and fuels by 2030. In turn, nine blue chip companies have committed to shift 100% of their ocean freight to zero carbon options by 2040, including Amazon, Ikea, Michelin and Unilever. Finally, 19 countries have

The methane pledge aims for a 30% reduction by 2030.

signed the Clydebank declaration to support the establishment of six zero-emission shipping routes by the middle of this decade with more by 2030. With the International Maritime Organisation meeting in less than two weeks to negotiate emissions standards, this is a positive move that should pave the way for productive talks.

The focus moves beyond coal

Outside of corporate pledges, the final text of the Glasgow Climate Pact references the phase-down of inefficient fossil fuel subsidies. This had already been announced by the G20, but giving the commitment a global stage adds emphasis and scope for further debate. However, the term "inefficient" provides a lot of flexibility for nations, including the UK, which are not ready to phase these subsidies out yet. Currently, fossil fuel subsidies amount to around half a trillion dollars per year – far outstripping subsidies for renewables.

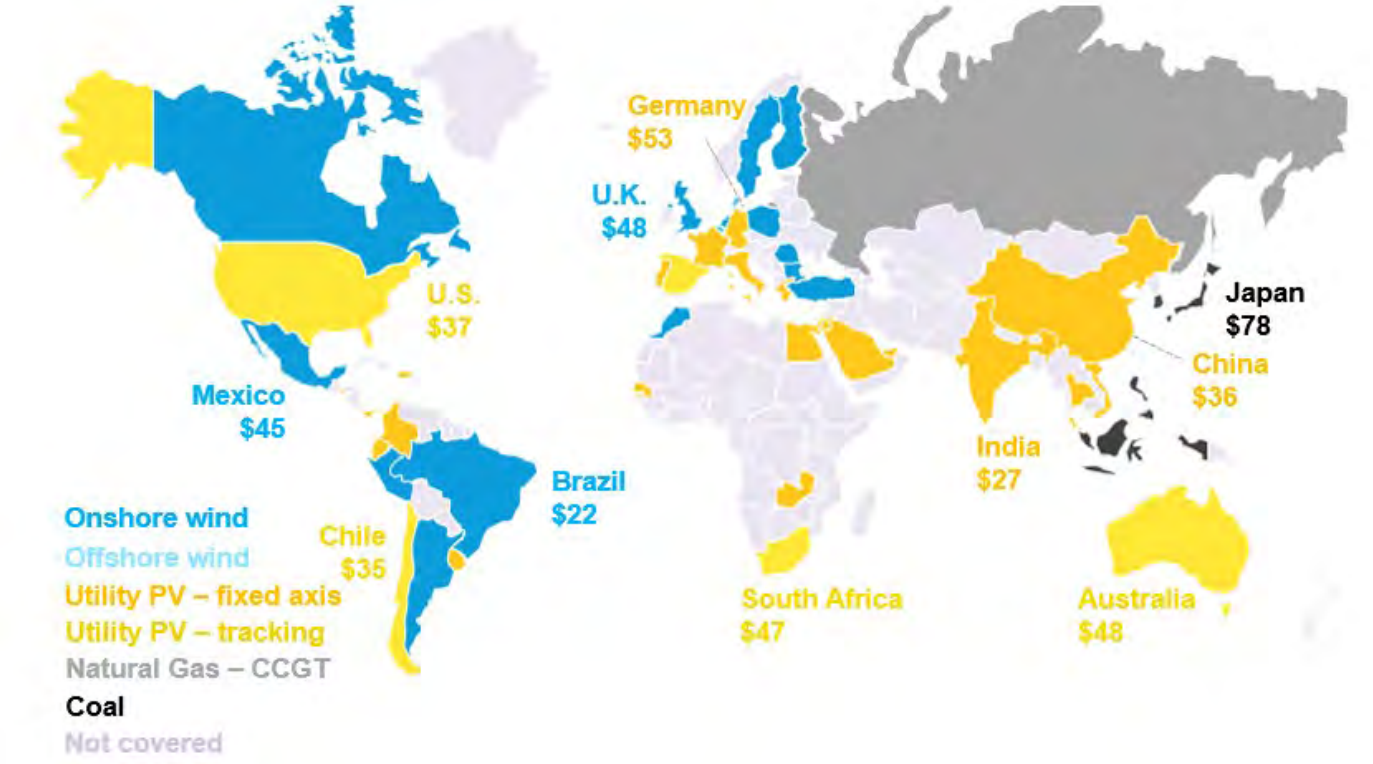
A "Beyond Oil and Gas Alliance" also emerged, with Denmark, Wales, Costa Rica, California, France, Sweden, Greenland, New Zealand, Portugal and Quebec signing up. The commitment involves ending new exploration permits for oil and gas. None of these nations are major producers, so this will not drive any significant impact, but it shows the pressure that governments are under to address the supply side instead of focusing purely on demand reduction. This is obviously not the optimum tactic when considering recent energy price volatility but, as we have previously written, we are in for a bumpy ride to net zero.

Finally, more than 30 countries and financial institutions signed a statement committing to halting all direct public financing for fossil fuel development overseas by the end of 2022 and diverting the spending to green energy. This comes hot on the heels of a similar announcement ending public financing for coal. Canada signed up, which is significant as the largest funder of fossil fuels in the G20, as did the US, the UK and Germany. The commitment has the potential to shift $23.6 billion of fossil fuel investment to clean energy.[5] However, Japan, Korea and China are the biggest providers of this finance globally and have not yet signed the wider fossil fuel agreement. A report by Climate Analytics was released to coincide with COP, which outlines that by 2030 gas will be responsible for 70% of the projected increase in fossil CO_2 emissions and 60% of the methane. Expect attention to intensify on this transition fuel.

An innovative "just transition" coal phase-out partnership with South Africa was announced,[6] which will provide $8.5 billion to support South Africa in moving to clean energy while aiming to avoid the negative social implications of shutting down a major industry. The country has one of the most coal-intensive grids globally and an economy heavily dependent on the fossil fuel. This could work as a template for other regions and discussions have already begun with countries like Indonesia.

Leading technologies for new bulk electricity generation are shown in Figure 2 by geography, with renewables leading the way in countries representing more than two-thirds of the world population and 91% of electricity generation. Similar mechanisms to South Africa's will be needed to support a just transition away from coal.

Figure 2: Cheapest source of bulk generation, H1 2021.



Source: BloombergNEF. Note: The map shows the technology with the lowest levelised cost of energy (LCOE) for new-build plants in each country where BNEF has data. The dollar numbers denote the per-MWh benchmark levelised-cost of the cheapest technology. All LCOEs are in nominal terms. Calculations exclude subsidies, tax credit or grid connection costs. CCGT = combined-cycle gas turbine.

Net-zero pledges

Scrutiny of dodgy net-zero targets is increasing, and will continue to do so. "More than 80% of global GDP – and 77% of global greenhouse gases – are now covered by a national net-zero target, up from 68% and 61% last year", according to a new tracker co-led by the University of Oxford.[7] "That number shrinks to 10% of global GDP and 5% of global emissions if only strong commitments and clear plans are included."[8]

The US published its plan during COP26 to achieve net zero,[9] with the UK doing likewise in the run up to COP.[10] These add credibility and pave the way for other nations and corporations to follow suit.

As this happens, expect to see the University of Oxford's 10% GDP and 5% emissions of credible targets start to close the gap to the 80%/77% announced. The UN has also announced an oversight body for net-zero targets.[11]

Source:

1 Note: source of all data, unless otherwise stated, is https://ukcop26.org/
2 https://www.iea.org/reports/curtailing-methane-emissions-from-fossil-fuel-operations
3 https://www.unido.org/IDDI
4 https://www.weforum.org/first-movers-coalition
5 https://www.e3g.org/news/coal-cop26-ending-international-public-fossil-finance-coal-done-oil-and-gas-began/
6 https://www.gov.uk/government/news/joint-statement-international-just-energy-transition-partnership
7 https://zerotracker.net/
8 https://www.ox.ac.uk/news/2021-11-01-80-world-economy-now-aiming-net-zero-not-all-pledges-are-equal
9 https://www.whitehouse.gov/wp-content/uploads/2021/10/US-Long-Term-Strategy.pdf
10 https://www.gov.uk/government/publications/net-zero-strategy
11 https://www.un.org/en/climatechange/net-zero-coalition

03 Country Head focus

Jon Allen
Head of Asia Pacific

The market is dominated by Japan, Australia and New Zealand, but recent net-zero declarations from China and South Korea signal that growth beyond the leading group is about to accelerate.

Anyone seeking proof that Asian economies are mobilising to address climate change need only look at global gas prices. The current spike is being driven in part by a "dash for gas" in Asia as governments in the region move to clean up their energy systems. Surging energy demand as economies rebound from the pandemic has driven gas prices in Asia to record levels amid fierce global competition to secure shipments of liquefied natural gas (LNG). "Asia will account for an incredible 95% of LNG demand growth between 2020 and 2022," according to energy analyst Wood Mackenzie.[1]

The intensifying focus on climate change across Asia over the past year has been powerfully reinforced by the impact of the Covid-19 pandemic. In the closing months of 2020, China, Japan and South Korea all announced plans to reach net-zero carbon emissions[2] – Japan and Korea by 2050, China a decade later. All three put investment in decarbonisation at the heart of economic stimulus plans to speed the recovery from the pandemic.

For investors these declarations of intent from the world's second, third and 12th largest economies herald a surge in sustainability-linked investment across a region set to be the critical engine of global economic growth. Asia is forecast to double its share of global GDP to more than 50% by the middle of this century, which will require huge investments in sustainable infrastructure and urbanisation projects.

ESG's historical strongholds in Asia

Historically, the leaders in sustainable investing in Asia and Australasia have been the largest institutions in Australia and New Zealand, notably the former's huge superannuation funds built up over the past 30-plus years. These pension vehicles were key early adopters of environment, social and governance (ESG) investment principles, especially since the launch of the UN's Principles for Responsible Investment in 2007. Initially focusing on governance, more recently they have become deeply engaged in environmental and social issues. Australasia had sustainable assets of $906 billion at the end of 2019, up almost 25% over two years, according to the 2020 biennial report produced by the Global Sustainable Investment Alliance (GSIA).[3]

Elsewhere in Asia, institutions such as public pension and sovereign wealth funds have recently brought responsible investment principles into the mainstream, encouraging external asset managers to integrate ESG principles into their investment processes. In 2016, the Korea Investment Corporation formed its

responsible investment taskforce as a first step in its transition to adopting sustainable investment practices. Also in 2016, Singapore's GIC set up its sustainability committee[4] to oversee its responsible investment framework.

Alongside Australasia, the other leading centre of sustainable investment in Asia is Japan, where in 2015 the Government Pension Investment Fund (GPIF), the world's largest pool of retirement savings, signed the UN's Principles for Responsible Investment,[5] the most popular sustainable investment framework globally. The following year the GPIF announced its intention to raise its allocation to ESG investments from 3% to 10%, which helped bring about a rapid increase in the country's stock of sustainable assets and spread adoption of ESG principles through Japan's corporate sector: between 2016 and 2018 its sustainable assets quadrupled to $2.18 trillion, and by the end of March 2020 they stood at $2.87 trillion, according to GISA.[6]

Investors intend to increase exposure

Since the beginning of the pandemic there are signs to suggest Asian institutions will accelerate their ESG-linked investments. MSCI's Investment Insights report for 2021 [7] found that 79% of institutional investors in Asia-Pacific planned to do so, either significantly or moderately, as a response to Covid compared with 78% in the US and 68% in EMEA.[8] MSCI surveyed 200 institutional investors globally in September 2020, a third of whom were based in Asia-Pacific.

Almost all the survey's Asian respondents came from the region's leading markets for sustainable investment – Australia, New Zealand and Japan. Only around eight of the 200 institutions canvassed were based in other Asian countries. This suggests that, once sustainable investment expertise and opportunities become more widespread in less developed markets, there could be much greater scope for growth in sustainable investment across the region than MSCI's research implies.

Regulatory changes to increase transparency around ESG investment processes are likely to be a catalyst for this, along with major institutional investors, which have historically been the earliest adopters in other Asian markets. However, adoption of ESG principles is also likely to be reinforced by growing interest among wealthy private clients, which is encouraging private banks and wealth managers to expand their ESG offerings. The next generation, especially, generally shows high levels of concern about ESG issues in surveys.

Fund flows started to surge in mid-2020

Data from Morningstar on sustainable fund flows and assets in public-market vehicles show that even though Asia lags Europe and the US, demand for ESG investments in the leading Asian markets is growing. "Except for Australasia and Japan, net inflows [globally] edged down across the board in the second quarter [of 2021]," Morningstar reports.[9]

Its data shows that, as in other parts of the world, sustainability-linked investment assets in Asia-Pacific started to grow more quickly from the middle of 2020 and continue to do so, although the rate of progress is not uniform. Over that period, assets held in Australasian ESG funds rose around 80% to $25.2 billion, Japan surged more than fivefold to $26.8 billion and Asia ex-Japan[10] more than doubled to just over $35 billion.

There is also evidence that the pandemic has had a major effect on the mix of sustainable fixed income assets issued in the region. The Sustainable Debt Global State of the Market 2020 report,[11] published by the Climate Bonds Initiative, shows that as tackling the pandemic became governments' top priority, issuance of green bonds in Asia slowed. The regional total dipped in 2020 to just over $50 billion – roughly level with the US. Within the Asian figure China accounted for $22.4 billion, down from $31.4 billion in 2019, making it the fourth-biggest issuer globally after the US, Germany and France.

However, the slowdown in issuance of green bonds across Asia was more than offset by a massive increase in sales of social bonds to fund pandemic-linked health and social investments. Globally, the total jumped tenfold to $249 billion in 2020. Asia accounted for nearly half that total, the great majority coming from Chinese entities.[12]

The momentum has been maintained this year. In the first half of 2021 Asian issuance of cross-border green bonds was already 50% higher than the total for the whole of 2020, at more than $30 billion. Overall issuance of green, social, sustainability and sustainability-linked bonds had topped $50 billion by the end of June, far surpassing 2020's annual total of around $34 billion. Some 17% of cross-border bond issuance in Asia-Pacific carried an ESG label in the first half of this year compared with just 7% last year.[13]

Climate risk versus the growth imperative

The accelerating growth rate of sustainable investment across Asia over the past year has been reinforced by two major factors: government stimulus measures to speed the recovery from Covid, and rising alarm at the growing impact of climate change.

Asia is hugely exposed to climate risks, as recent floods, wildfires and other extreme events demonstrate. According to McKinsey, large cities in south Asia could be "among the first places in the world to experience heat waves that exceed the survivability threshold for healthy human beings in the shade".[14] Parts of east Asia may face a three-to-fourfold increase in extreme rainfall events by 2050, while three-quarters of the global impact of riverine flooding could be felt in Asia, damaging around $1.2 trillion of capital stock per year by 2050. Areas of China could spend four to six years per decade in drought by then, with up to eight years possible in south-western Australia.

However, Asia will also be the main locus of global economic growth over the next few decades. This will require huge investments in infrastructure and urbanisation that will expand the Asian market for sustainable investment initiatives. Funding this transformation is set to make sustainable investment a dominant theme in Asia over the coming decades.

Conclusion

It will be years before the stock of sustainable investment assets across the region rivals Europe and North America. But fund flows have accelerated significantly, and progress is being made in areas that will be vital to support a major expansion in sustainable investment.

The most important leading indicator of future progress in Asia's less developed markets for ESG investment is likely to be regulatory change. On this score there are grounds for optimism: financial regulators across the region are increasing the pace of reforms that will support the growth of sustainable investment markets; Singapore is expected to set out disclosure standards for retail ESG funds in early 2022;[15] while Taiwan's Financial Supervisory Commission published a disclosure framework for ESG mutual funds in July 2021.[16] Companies listed in Hong Kong will be required to make detailed disclosures in line with the framework set out by the Taskforce on Climate-Related Financial Disclosures no later than 2025.[17]

Moves such as these will power the spread of sustainable investment beyond its current strongholds in Australia, New Zealand and Japan over the next few years and open up major new opportunities across the wider region.

Source:
1 https://www.woodmac.com/news/opinion/how-asia-changed-the-global-lng-market-in-the-space-of-a-year/, April 2021.
2 https://www.carbonbrief.org/daily-brief/south-korea-follows-japan-and-china-in-carbon-neutral-pledge, October 2020.
3 http://www.gsi-alliance.org/trends-report-2020/
4 https://www.gic.com.sg/wp-content/uploads/2021/04/GIC-Thinkspace-Sustainability-An-Enterprise-Journey.pdf
5 http://www.env.go.jp/en/policy/esg/pdf/ESG_WG_report.pdf, January 2017.
6 http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf
7 https://www.msci.com/our-clients/asset-owners/investment-insights-report
8 https://www.msci.com/documents/1296102/22910163/MSCI-Investment-Insights-2021-Report.pdf
9 Morningstar, Global Sustainable Fund Flows: Q2 2021 in Review.
10 Comprising China, Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, Taiwan and Thailand.
11 https://www.climatebonds.net/files/reports/cbi_sd_sotm_2020_04d.pdf
12 https://www.climatebonds.net/files/reports/cbi_sd_sotm_2020_04d.pdf
13 https://www.investmentbank.barclays.com/our-insights/3-point-perspective/ESG-financing-surges-ahead-in-Asia-Pacific.html
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04 Why effective carbon pricing can be pivotal in accelerating the net-zero transition

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Carbon pricing is a critical policy tool to promote decarbonisation and achieve CO_2 emission reductions in line with the goals of the Paris Agreement on climate change. We take a closer look at the role of carbon pricing, the range of global carbon pricing schemes and what analysts, portfolio managers and advisors should know about the potential impacts of carbon pricing on companies, sectors and the broader economy.

What will it take to decarbonise in time?

Actions are being taken by governments and industry to catch up and get ahead of critical emissions goals and benchmarks. Catalysts on the road to net zero include national and regional carbon markets and climate regulation, and the development of new clean energy technologies by corporations. In the EU, the Emissions Trading Scheme (ETS) reforms – announced as part of the EU Fit for 55 Package – aim to align the carbon market with interim 2030 climate targets, while enhanced climate regulations will include policies on renewables and energy taxation. In the US, the Biden administration's infrastructure plan considers a wide range of climate policies such as clean electricity standards and fiscal incentives for renewables and clean technologies, which are expected to be enacted in legislation in some form by the end of the year. At the same time, state-level policies are seeking to address carbon pricing and renewables standards. Governments, investors and consumers are also bringing pressure on corporations to make meaningful commitments to decarbonisation.

Carbon pricing: an essential tool to achieving net zero

Carbon pricing will be a key component in achieving CO_2 emission reductions in line with the goals set in the Paris Agreement and in accelerating the transition to net zero. Recognising this, more countries have begun to embrace carbon pricing to limit their emissions. But while carbon prices are rising, current prices remain too low to achieve necessary long-term decarbonisation. The International Energy Agency (IEA), International Monetary Fund (IMF) and World Bank, among others, estimate that a carbon price ranging between $75 and $100 per ton of CO_2 is needed to achieve the Paris Agreement's goals. Today, the IMF estimates that four-fifths of the world's carbon emissions remain unpriced, and that the average global price of carbon is less than $5 a ton.

There are three approaches to pricing carbon: carbon taxes, carbon compliance markets, and voluntary carbon markets or offsets.

1. Carbon taxes are a relatively easy fiscal policy instrument to implement. They set a direct price on carbon by defining a tax rate based on greenhouse gas (GHG) emissions or the carbon content of fossil fuels. With carbon taxes, the carbon price is fixed and there is no overall emissions cap, which means the exact overall emissions reduction will be implied by the carbon pricing.

However, there is often limited flexibility with carbon taxes since polluters can't pay other companies to reduce emissions when it is cheaper to do so. As countries are increasing the level of their commitments to net zero, they are also increasing carbon taxes to help meet these objectives. For example, Norway plans to more than triple its national tax on CO_2 emissions to $237/ton by 2030, while Canada plans to increase its national carbon tax more than five-fold from C$30 to C$170/ton by 2030.

2. Carbon compliance markets are based on a cap-and-trade model where a cap is set on total emissions permitted and reduced over time. A regulator allocates or sells allowances up to the limit set by the cap. Every year entities must retire enough allowances to cover all their emissions.

A penalty mechanism is usually embedded in the event of non-compliance. Carbon prices are market-based – entities with low emissions can sell surplus allowances to larger emitters, and the other way around. In our view, carbon compliance markets are the most effective framework for incentivising and realising emissions reductions (Figure 1).

Figure 1: Carbon compliance practical functioning

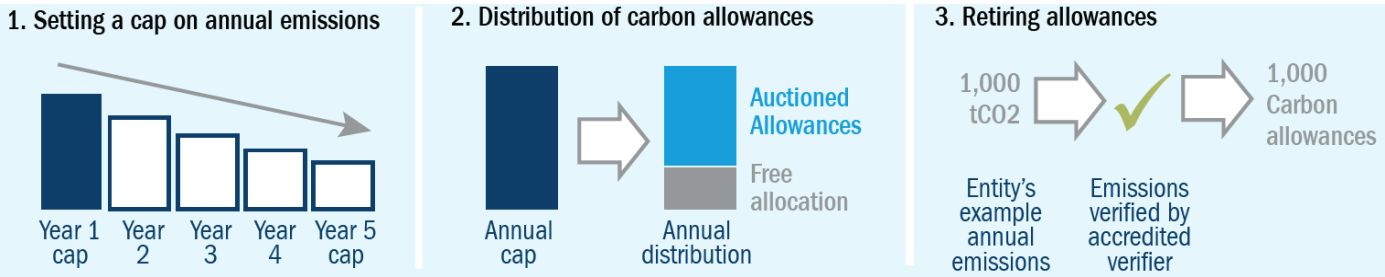
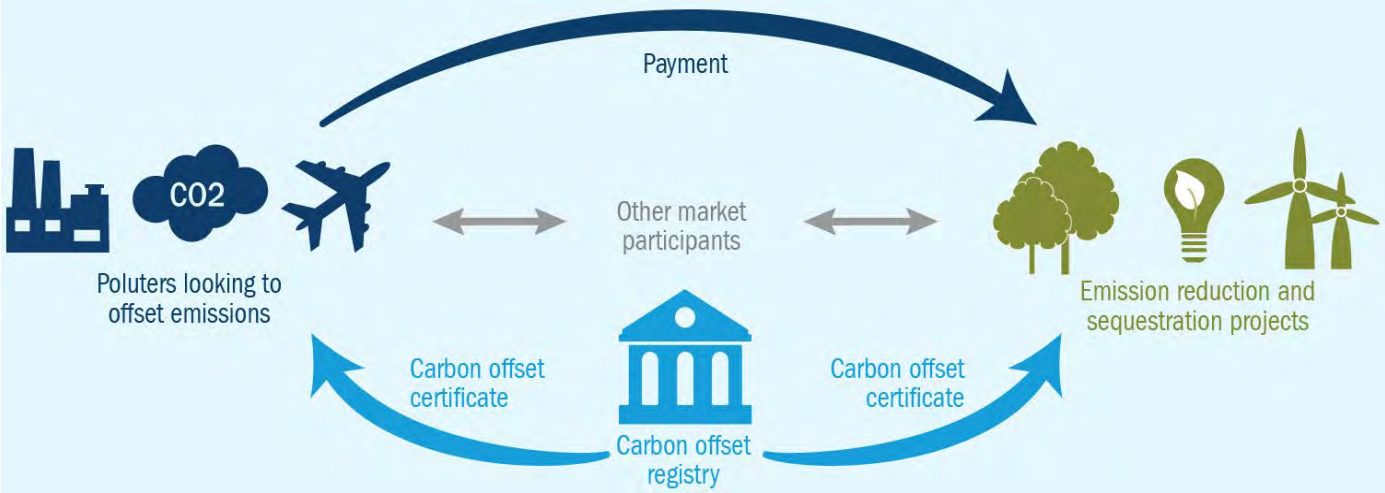


Figure 2: Carbon markets practical functioning



3. Voluntary carbon markets, or carbon offsets, present companies with an opportunity to address emissions they are unable to eliminate. These rest on the concept of companies being able to negate, or offset, the amount of emissions they release. An offset is created by directing funding to projects that reduce, avoid or remove CO_2 emissions from the atmosphere (Figure 2). The carbon price is market-based and depends on the supply of and demand for offsets.

Carbon offset projects include nature-based solutions like reforestation and afforestation, renewable energy and waste disposal. The outcomes need to be measurable, verified and proved effective. One big drawback of carbon offsets is that the market is fragmented and complex with a variety of different registries and methodologies. There is also a lack of standards, which presents the risk of "greenwashing" (ie, providing false or misleading information regarding the extent to which a product/company is environmentally sound). For this reason, carbon offsets are not currently considered to be a rigorous option or replacement for other more comprehensive emissions reduction solutions. Mark Carney's recently launched Task Force for Voluntary Carbon Markets initiative is trying to set standards on this market to contribute to the process of decarbonisation.

The current landscape of carbon markets

There are currently 64 different carbon pricing initiatives implemented globally, covering close to 22% of global GHG emissions. This suggests that not only is the global market not uniform, but that it is also heavily fragmented with a wide disparity in prices. Of these initiatives the EU ETS is the most developed and liquid. Other relevant carbon schemes include the recently launched Chinese national emissions trading system and the California Cap-and-Trade Program.

European Union

The EU ETS is the largest global carbon market and is considered the cornerstone policy for the EU to achieve its climate goals. It is viewed by many as a reference point for other potential programs and could potentially be replicated by other countries that wish to implement effective carbon pricing initiatives. The EU ETS is an entirely regulated cap-and-trade system that was launched in 2005. Carbon allowances are freely allocated (43%) or auctioned (57%), while industrials get around 90% of allocations for free. The EU ETS covers approximately 40% of the EU's GHG emissions and applies to more than 11,000 "heavy-energy-using installations" encompassing seven sectors: power, oil and gas, chemicals, ceramics/glass, pulp/paper, cement/lime, and metals. It was developed in phases, with phase IV starting this year and running through 2030. This seeks to reduce supply and free allowances through an emissions cap reduction

CCS technologies

Carbon Capture and Storage (CCS) technologies will play an instrumental role in decarbonisation. CCS is a process to remove CO_2 that results from industrial processes, power generation and manufacturing from the atmosphere. CCS will be a critical solution for hard-to-abate sectors like cement and steel where there is no easy alternative to reduce emissions from chemical processes.

The IEA estimates that CCS could help reduce around 15% of global emissions by 2050, which is a 100-fold increase from today. CCS technologies differ greatly in form and cost by application and industry, which means different carbon prices, supportive policies and government funding will be needed to make them commercially viable. However, these technologies are likely to remain very costly and higher carbon prices will be needed to reduce the gap.

at a linear reduction factor (LFR) and a market stability reserve to remove the surplus of allowances that has built up over the years.

EU regulations on the carbon market could have global implications. For example, the Fit for 55 EU climate package contemplates the introduction of a carbon border tax, which seeks to address the risk of "carbon leakage" and set a level playing field for EU industrials. This carbon border tax could have implications for non-EU industrials in the form of a levy on imported goods. The debate of this tool may have far-reaching implications and act as a catalyst to drive carbon taxes elsewhere.

China

China has been running emission trading scheme pilots across different regions since 2011. In July 2021 it launched its national ETS. While the scheme currently covers only power generation, it covers almost half of China's total carbon emissions, which equal 14% of total global emissions. The system lacks an absolute emissions cap limit and provides a high level of free allocation of allowances, which results in relatively low prices (under €7/ton), well below European carbon prices.

California

The California Cap-and-Trade Program began operating in 2013. It is the primary method the state is using to achieve its emission reduction plans, covering industries responsible for 85% of the state's GHG emissions. The mechanics of the program are very similar to the EU ETS – it has a cap on emissions and allowances are freely allocated or auctioned. While prices have risen since its inception, at less than $20 they remain relatively low.

Thus far, President Biden has made strong commitments on climate change, including rejoining the Paris Agreement, increasing the target for the new emissions reduction to 55% by 2030, and proposing the green infrastructure plan, which includes the introduction of new clean energy standards. However, Biden has not explicitly expressed public support for a national carbon pricing system, and the US is currently not contemplating implementing one, most likely due to the perceived difficulty of securing bipartisan support. Nonetheless, more states, including Pennsylvania, Washington and Virginia, are committing to ambitious climate targets and also announcing the implementation of state-level carbon pricing schemes.

A framework for analysing the impact of high carbon prices

As carbon prices change it could impact the profitability of different companies. We use the following parameters to assess the potential impact of higher carbon prices on a variety of sectors:

Carbon intensity. We look at the scope of company emissions and estimate the cost of generating this volume of emissions at a relatively higher carbon price. Comparing this cost relative to revenues helps frame the magnitude of the potential impact on profit-generating capacity.

Pass through ability. We analyse the ability of a company to pass on higher carbon costs to customers, which could be a very important mitigating factor. There are companies for which

carbon costs behave like a commodity, including utilities and chemicals such as steel and cement. These companies can fully pass the higher cost through to their end customers. So, despite being high-carbon-intensive sectors, higher carbon prices could have a moderate impact in the overall earnings before interest, taxes, depreciation, and amortisation (EBITDA).

Decarbonisation options. We assess how easily and costly it could be for a company within a specific sector to reduce carbon emissions, thereby offsetting the impact of higher carbon prices. For example, utilities have the potential to reduce emissions through renewables, which would reduce the sensitivity of this sector to higher carbon prices. Other sectors like aviation or chemicals rely on clean technologies that are still in development and/or not commercially available, such as sustainable fuels and hydrogen. Transition to net-zero emissions for these sectors could take longer, leaving them vulnerable to the impact of higher carbon prices.

We use these three lenses to evaluate the potential impact of higher carbon prices and assess whether the issuers within each sector are well or poorly positioned to adapt. Even in carbon intensive sectors, companies that implement immediate and credible CO_2 reduction plans and show strong pricing power should fare better than those that do not.

Bottom line

Net zero is going to impact all companies, in all industries – and this impact is starting now. Investors and their advisors should educate themselves on the potential impacts of carbon pricing on the economy and on companies in which they invest and consider how best to position their portfolios in light of decarbonisation initiatives.

05 Human rights, corporate wrongs & investment impacts

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Respect of human rights can help drive the long-term sustainability and success of any corporation. For certain strategies that target sustainable outcomes, we seek to invest in companies whose output is beneficial to society and achieved sustainably, respecting the rights of all stakeholders.

In considering human rights we need to understand how they have evolved, and continue to do so (Figure 1). The conventions by which we live were shaped after the second world war and directed at nation states to ensure basic economic, social, cultural and political rights. Life since then

Figure 1: A history of human rights

Source: United Nations/OHCHR/ILO.

has increasingly been influenced by multinational enterprises so scrutiny has shifted to the boardroom, though not yet through legally binding instruments.

In 2000, the UN Global Compact introduced non-binding principles for businesses to support and respect human rights, ensuring they are not complicit in abuse. The UN Guiding Principles on Business and Human Rights built on this foundation. The three pillars of the principles – protect, respect and remedy – reflect the responsibilities of nation states and corporations and the right of victims to redress if abuses take place. We may see the principles develop into a legally binding convention, with the UN Human Rights Council due to discuss the third draft of a Treaty on Business and Human Rights (BHR) in October 2021.

A ratified treaty could see businesses obliged to implement Human Rights Due Diligence (HRDD) and ensure access to effective remedy for victims of abuse. The obligations may extend to communities impacted – even indirectly – by business operations. The OECD Guidelines for Multinational Enterprises give us a taste of things to come: though not legally binding, the investigations it prompts can lead to legal and financial liabilities, and reputational damage.

A key weakness of the UNGP and OECD Guidelines concerns the lack of access to effective remedy for victims in developing countries. This issue is being addressed in the proposed BHR. The treaty introduces a state obligation to regulate corporates under their jurisdiction or control, including transnational activities. This means multinational enterprises may be liable for human rights abuse in their global supply chains. To date, it has been challenging for victims to seek redress in such circumstances. Attempts are usually made through the 1789 US Alien Tort Statute (ATS) or via tortuous mediation using the OECD Guidelines. A ratified BHR could make redress simpler, increasing the prospect of legal liabilities for companies without HRDD or those complicit in abuse.

Vigilant active management

As investors, we need to be vigilant for digressions and engage where we have concerns. While third-party data providers are useful in flagging potential concerns, changes in company scores and ratings are a starting point for us to research, engage and act. Where there is tangible evidence of mitigating action, we can justify ownership and promote dialogue to ensure concerns are addressed. In this way we build relationships with our companies and realise long-term value.

Teleperformance is a global digital integrated business services company listed in Paris. In early 2020, allegations of poor working conditions emerged as pandemic-induced lockdowns took hold. On engaging with management, it was clear they faced a logistical challenge but had acted to ensure employees' safety and wellbeing. When we spoke to the CFO in April, the company had transitioned over 40% of its workforce, or 120,000 people, to working from home. Those who could not were being employed in a clean office environment, open to independent inspection. Actions were co-ordinated through an Executive Crisis Committee, which met daily, and a broader forum of 100 senior business leaders.

After our meeting, UNI Global Union, an international labour union, submitted a case to the National Contact Point (NCP) in France alleging contravention of the OECD Guidelines. An ESG data provider cut Teleperformance's rating. But we maintained a positive view as we had evidence of remediation. We followed managers' progress closely, meeting with the investor relations team in June and the Deputy CEO in August 2020.

The NCP mediation process between Teleperformance and UNI resulted in a Final Statement on 5 July 2021, summarised in the following excerpt:[1] "The NCP notes that, following an emergency management phase, Teleperformance has deployed and continues to implement a policy to prevent, manage and monitor the pandemic in all its subsidiaries in order to address health risks associated with the pandemic. This policy broadly corresponds to the expectations of corporate due diligence recommended by the OECD Guidelines."

While the NCP Final Statement confirms mitigating action, the deterioration in dialogue between UNI and Teleperformance highlights the challenges of mediation under a non-binding framework. The legal basis provided by a treaty could ensure more rigorous negotiation and settlement. We continue to monitor Teleperformance's progress; the Covid-19 pandemic may have permanently changed its operating model, return profile and growth prospects.

A second case concerns Nestlé, one of the world's largest food and beverage brands. Rather than pursuing OECD mediation, complainants alleged human rights abuses by Nestlé, as well as other firms, using the US ATS. The lawsuit was dismissed in June 2021 as the ATS could not be applied extraterritorially. However, it highlighted the problem of child labour and forced labour across global commodity supply chains. While already aware of Nestlé's progress in this area, the case prompted us to review its HRDD policies and practices. We held a call with the Head of its Cocoa Plan, the supply chain in which the abuses were alleged.

Nestlé launched its Cocoa Plan in 2009 to help farmers improve their livelihoods through education and community support. It was the first in the industry to develop a Child Labour Monitoring and Remediation System (CLMRS) in 2012, acknowledging problems highlighted by independent assessors. Impact assessments published by the Fair Labor Association and the Danish Institute for Human Rights are evidence of progress. In 2019, the CLMRS had grown to monitor 78,580 children and engaged with 15,740 of them to prevent underage employment. This is achieved through initiatives ranging from facilitating access to education by providing birth certificates, to offering bridging classes and vocational training.[2]

Nestlé sources 46% of its cocoa sustainably through the Cocoa Plan, and has an ambitious 100% target for 2025.[3] Progress towards this goal was key when we decided to invest for the Pan European Sustainable Outcomes strategy. Nestlé's integration of human rights into its policies and practices is shown through a variety of ongoing initiatives aimed at systemic change. For example, it is helping children re-enter education, pooling labour to avoid their employment, raising household earnings through income-generating activities for women and agricultural training to boost yields by up to 4x. While some, including ESG ratings agencies, penalise Nestlé for the presence of child labour, we praise its transparency and ongoing efforts to address it. Controversy still exists, but tangible mitigating action is evident.

These case studies illustrate the challenges involved in controversy analysis and anticipating regulatory change in the field of human rights. Controversy presents risks and opportunities, and as much depends on mitigating actions as the circumstances in which it was created. We anticipate further scrutiny in the wake of BHR discussions in October and are already holding companies to account as investor and regulatory expectations rise. This focus on human rights will remain a cornerstone of our approach in the Pan European Sustainable Outcomes strategy.

Source:

1 OECD, https://mneguidelines.oecd.org/database/instances/fr0030.htm, 2021.
2 https://www.nestle.com/sites/default/files/2019-12/nestle-tackling-child-labor-report-2019-en.pdf
3 As of 2020. https://www.nestle.com/csv/raw-materials/nestle-cocoa-plan

STEWARDSHIP IN ACTION

Our stewardship activities are integral to our investment process, helping us to detect inflection points and long-term trends, and influence companies' standards around ESG risk management and sustainable outcomes. A key focus is to enhance our investment research so that we can make informed capital allocation decisions as active investors.

The ultimate goal of our stewardship approach is to enhance our understanding of risks and opportunities, strengthening our ability to deliver sustainable long-term value for clients. In approaching these responsibilities we are mindful of market trends; company, local market and industry-specific issues; and relevant best-practice standards – but we will ultimately be guided by what is in the best long-term economic interests of our clients.

The research and analysis emerging from this, and the ongoing engagement with companies, is disseminated globally throughout the firm as part of our culture of research intensity and helps us identify potential issues at an early stage.

In prioritising our engagement work, we focus our efforts on the more financially material or contentious issues and themes, and the issuers in which we have large holdings. There are many companies with which we have ongoing engagements, as well as a number that we speak to on a more ad hoc basis, as concerns or issues arise.

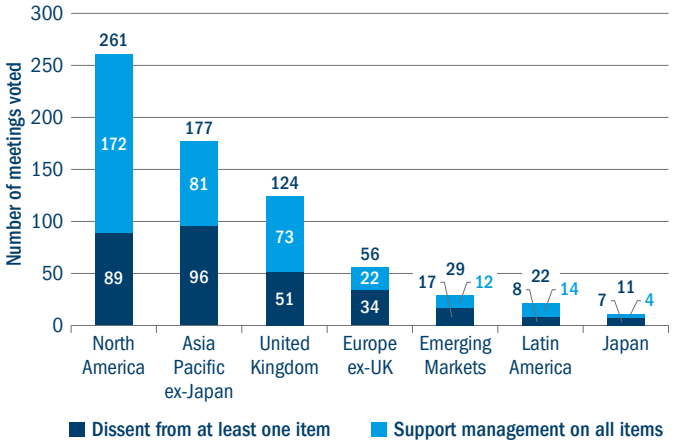
We vote actively at company meetings. We view this as one of the most effective ways to signal approval (or otherwise) of a company's governance, management, board and strategy, or standards of operating practice. While analysing meeting agendas and making voting decisions, we use a range of research sources and consider various ESG issues, including companies' risk management practices and evidence of any controversies.

Our final voting decisions take account of research issued by proxy advisory organisations such as ISS, IVIS and Glass Lewis, as well as MSCI ESG Research. Although we subscribe to proxy advisors' research, votes are determined under our own custom voting policy. Within this, material or controversial proposals receive enhanced due diligence and are voted on by the investment team, with support from the RI team. Votes are cast identically across all mandates for which we have voting authority. All our voting decisions are available for inspection on our website seven days after each company meeting in EMEA/APAC, and are updated annually in September in the US.

06 Voting Q3

Between July and September 2021 we voted at 680 meetings across 41 global markets. This compares to 3,993 meetings voted across 58 global markets in the previous quarter (Q2). Of the 680 meetings, 459 were annual general meetings, 198 special, 10 combined annual/special, six court, three proxy contests and two written consent and bondholder meetings. We cast at least one dissenting vote in 302 meetings (45%).

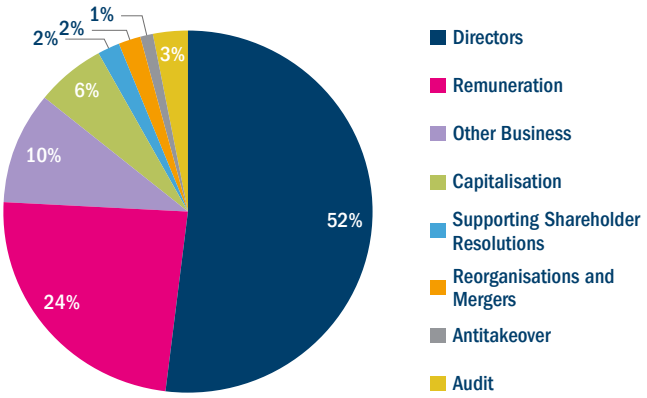
Figure 1: Meetings voted by region



Source: Columbia Threadneedle Investments, ISS ProxyExchange, 30 September 2021.

We voted in 41 separate markets in the third quarter. Most meetings were voted in the United States (252), followed by United Kingdom (105) and India (82).
The majority of the voting items that we did not support throughout the quarter continue to be related to directors, followed by Remuneration and Other Business related proposals.

Figure 2 Data: Proportion of dissenting votes per category



Source: Columbia Threadneedle Investments, ISS ProxyExchange, 30 September 2021.

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