

# Foundation Approaches to Climate Change Investing



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Climate risk touches many companies across different business segments. On one side, risks posed by climate change may cover areas such as an increase in instances of large scale storms, rising temperatures and increasing

water levels, and on the other these risks stem from potential impacts in the business environment around changing regulatory frameworks related to fossil fuels and the development and transition to technologies like alternative energies. Nonprofits invest with a long time horizon. Like many other investors, nonprofits are concerned with the financial health and sustainability of the companies that make up their portfolio as they have a stake in their long-term success. It should come as no surprise then that certain institutional investors, including nonprofits, are considering climate related risks as a potential risk to the long term financial success of their portfolio. As the US SIF observes, nonprofits distinguish



themselves from other institutional investors, however, because they have a specific philanthropic mission<sup>[1]</sup>. While each mission is specific, be it related to serving a specific community, protection of biodiversity, serving ecologically sensitive locations, supporting underserved or vulnerable populations or otherwise, the reach of climate change impacts may pose a concern to the long term goals and objectives of these missions, which may underscore a greater or enhanced focus on incorporating these risks into the investment philosophy. In the US, the application of climate change criteria in the investment process by all asset owners in 2016 impacted \$1.42 trillion in assets; five times greater than 2014 levels<sup>[2]</sup>. This growth reflects the appetite of US asset owners to incorporate these risks into their investment philosophy and particularly for certain nonprofits, bringing alignment of their mission related focus to broader activities beyond traditional grant making and donation strategies.

## **What is Climate Change**

The Earth's climate goes through cycles, and we are currently experiencing a warming trend. According to NASA, the significance of this trend from previous cycles is that it is moving at a faster rate, and that is likely driven by human activity. This is attributed largely to increasing levels of atmospheric carbon dioxide and other gases produced by the use of fossil fuels. These greenhouse gases trap heat in the atmosphere, resulting in global warming. Climate Change refers to the range of changes to the Earth's climate and weather patterns, encompassing global warming as well as the consequences of this warming, including rising sea levels and accelerated melting of glaciers and polar ice. The critical thing to remember in climate change is that it is not a single crisis but a cumulative effect.

## **Why is it relevant to investors**

According to the Economist Intelligence Unit<sup>[3]</sup>, a rise in global temperatures of five degrees Celsius between 2013 and 2100 would result in \$7 trillion in investment portfolio losses, discounted to present value. There is a high probability that a significant proportion of proved and probable fossil fuel reserves will become stranded assets; that is to say that these assets will not be monetized as a result of changing carbon regulation and shifts in the market to renewable and alternative energy.

Technological shifts and greater adoption of alternative energies could further contribute to loss of investor confidence in fossil fuel stock performance. Alternative energies have experienced decreased costs, and some forecasts suggest solar energy will constitute up to 23% of global power usage by 2040. The shift to electric cars is expanding into major emerging markets, and use of electric vehicles may account for 35% of road transport by 2035<sup>[4]</sup>. As alternative energies become more accessible and cost effective, consumer shifts to more sustainable options may displace fossil fuel consumption in a meaningful way.

## **Policy Changes**

As the 2015 Paris Conference of Parties and various conventions have called for more stringent carbon regulations, 149 countries including the U.S. have submitted their targets to decarbonize their economies. In June 2017, however, the US federal government announced

plans to exit the Paris Agreement, an international agreement designed to combat climate change. This policy change was largely based on concerns over the potential impact to jobs growth in the United States – though not supported by the majority of economists and international organizations<sup>[5]</sup>. The immediate reaction from several American businesses, cities and states communicated an intention to continue to address climate change risks, including several states and municipalities communicating their own carbon reduction targets and renewable energy usage goals.

Investor demand for low carbon and fossil fuel free investing capabilities has been growing and we expect the momentum behind it will continue to grow regardless of this policy change, as evidenced by state governments and companies proclaiming their intention to abide by the Paris Accord. Nonprofits were no exclusion. The 2016 US SIF Trends Report indicated that environmental issues like clean technology, fossil fuel divestment, and climate change and carbon issues, represented prominent approaches to the ESG investment strategies employed by philanthropic organizations<sup>[6]</sup>. There are quite a few viable investment strategies and products poised to support the continued adoption of climate-focused investment strategies.

## **Options and key considerations**

There are a number of options available to investors who want to limit their investment exposure to fossil fuels.

### **1. DIVESTMENT**

A straight forward approach to decarbonizing a portfolio is to divest from companies that own fossil fuel reserves. Some investors may choose to divest from the owners of reserves as well as companies who are highly dependent on fossil fuels in their value chain, such as refineries, equipment and service providers or fossil fuel transport companies. This approach entails a sector bet on the future low carbon economy at a point when the transition has not yet been fully formed. As certain fossil fuel heavy corporations undertake changes to their business models to diversify and develop renewable capabilities, the role of these companies in a low carbon economy is as of yet unclear. From an economic perspective, divestment may expose investors to the risk of short-term price movements due to the cyclical nature of energy stocks, and as such, the impact of full divestment on performance is not clear at this point. Furthermore, it does not allow engaging with the high-carbon companies to foster their transition to greener business models.

### **2. REINVEST**

Alongside a divestment strategy, certain climate aware investors transition their energy exposure to companies providing climate solutions, like renewable energy storage or production. Pure play clean energy stocks may be volatile and may expose investors to higher, unnecessary risks. The pool of equity issuers in this space has been growing over the past few years, and as such there are greater investment opportunities across different asset classes.

### 3. GREEN BONDS

The level of outstanding green bond issuances have more than quadrupled in the past two years, but nonetheless constitutes a very small portion of the total bond universe and many remain insufficiently liquid for many investors. There are recent efforts to categorize and certify the 'greenness' of the bonds to ensure issuances where proceeds are used to finance highly environmentally impactful projects. There are however opportunities to include green bonds into conventional fixed income portfolios where credit and liquidity characteristics meet the investors criteria as a portion of a fixed income strategy.

### 4. NUANCED DIVESTMENT

Certain investors are taking a more nuanced approach to divestment, targeting to limit their exposure to fossil fuel companies by excluding only the companies with the highest carbon content based on the revenue exposure or the size of potential carbon emissions and current operational carbon emissions (scope 1 and 2 emissions). This approach would cast a wider net in terms of excluding companies with high rates of burning fossil fuels today in the absence of ownership of reserves, while allowing investment in select fossil fuel companies. Maintaining investment in select fossil fuel companies may be a good solution for certain investors for the following reasons:

1. Leadership – as fossil fuel reserve owners may also be active in the transition to a low carbon economy through the research and development of alternative energies, or diversifying their fuel mix
2. Engagement – A key tool available to investors is active ownership through engagement and proxy voting. Investors and asset managers engage with companies in high risk sectors to increase transparency and reporting around a commitment to transition to a low carbon economy.
3. Performance – to help investors manage their financial performance, these approaches tend to incorporate controls over tracking error, and have in some cases performed consistent with, or exceeded their benchmark. Research has shown that low-carbon indices generally perform at a minimum in line with and at times better than standard market cap weighted benchmarks<sup>[7]</sup>.

## Conclusion

Interest in climate-related investing has grown considerably over recent years; so too have the available capabilities that have been developed to support nonprofits in aligning their mission with their investment strategies. Incorporating a climate-focused strategy in the investment philosophy of a nonprofit organization may be a natural fit as it may align with the investment goals as well as the mission of the organization, but a critical step is to determine the approach that and strategy that fits with the mission and goals of the organization. As there is no one size fits all approach to climate investing, it is for each organization to define their vision of success for a climate-focused investment approach, taking into account not only the goals of their mission but embedding these environmental goals in an investment thesis that is sensitive to the organization's performance objectives. A shift in investment philosophy and policy should be undertaken as part of a broader partnership with your investment advisor or portfolio manager so that the right approach can be chosen and successfully integrated into the investment program.



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[1] *Unleashing the Potential of US Foundation Endowments: Using Responsible Investment to Strengthen Endowment Oversight and Enhance Impact*, 2014 US SIF Foundation

[2] *The Impact of Sustainable and Responsible Investment*, 2016, US SIF Foundation

[3] Economist Intelligence Unit, "The Cost of Inaction: Recognizing the Value at Risk from Climate Change". 2015. Importantly, this present value of losses has been based on the discount rate of a private investor. When the expected losses are considered from the point of view of a g

[4] *Expect the Unexpected: The Disruptive Power of Low-carbon Technology*". Carbon Tracker and the Grantham Institute at Imperial College London. February 2017

[5] OECD report '[Investing in Climate, Investing in Growth](#)' states that a policy package that matches climate change targets could add 1% to average economic output in G20 countries by 2021 (in the next 5 years). This would rise to 2.8% by 2050. If the economic benefits of avoiding the negative impacts from climate change such as increased flooding are factored in, the net increase to the value of goods and services or GDP produced by the G20 would be nearly 5% by 2050.

[6] *The Impact of Sustainable and Responsible Investment*, 2016, US SIF Foundation

[7] M.Anderson, P.Bolton, F.Samama. *Hedging Climate Risk*. *Financial Analysis Journal*. Volume 72.Number 3. 2016. CFA Institute

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