Key Questions

# Could Climate Change Affect My Portfolio?

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## Climate change impact is being felt near and far, with the trend toward sustainability gaining strength. If companies don't take it seriously, it could affect your portfolio.

While climate change may be a hotly debated topic in some circles, there is a strong and growing movement to address it. Corporations are adopting practices to improve their environmental profiles, while governments and non-profit organizations are implementing policies to reduce their carbon footprints. In the investment world, assets are pouring into managers that are focused on Environmental, Social, and Governance (ESG) factors and sustainability.

Regardless of one's views on the causes or solutions, the impact of climate change and the risks associated with global warming are significant and affect all corners of our earth. There are daily reminders of the horrific destruction caused by the increase in extreme weather patterns, including wildfires, severe droughts, rising sea levels, and hurricanes. As a result, organizations ranging from cities to pension funds to municipal bond rating agencies are taking the risks of climate change seriously.

From a company's perspective, the risks of climate change include not only the physical risk of a direct disruption to operations but also the regulatory liability and reputational risks for failure to be good environmental stewards.

The business risk from the transition to a low carbon economy is another serious threat that may be underappreciated. A company's business, investors, and stakeholders could be impacted if such risks are not addressed.

ESG investment managers have been ahead of the pack in thinking about carbon exposure, climate risks, and the overall sustainability profiles of companies for purposes of both value alignment and long-term profitability. Their view is that well-governed companies with proactive environmental strategies have a lower risk profile, enjoy significant cost savings through resource efficiency, benefit from a lower cost of capital, and provide better outcomes both for investors and the environment. Actual results and a growing number of research papers — including academic studies that document a correlation between lower carbon emissions and higher profitability — support this thesis.

As part of their sustainability efforts, many ESG managers devote significant efforts as shareholders to engage with their portfolio companies. These investment managers seek to ensure that businesses adequately disclose and manage their ESG risks, and they often advocate for changes if companies don't. Large shareholders are in the driver's seat here, and more and more organizations are acquiescing to their demands. Parnassus Investments, a San Francisco-based money manager, was one of several investors that pushed Oreo cookie-maker Mondelez International to assess the environmental impact of its packaging. After years of resisting, Mondelez announced last May that all its wrappers would be recyclable by 2025.

Climate change was further headlined this past week as CEO Larry Fink of Blackrock, the world's largest asset manager, announced a renewed focus on the environmental issues in his annual letter to chief executives. Fink has always been a supporter of sustainability, but this declaration raises his leadership profile and commitment to the cause to a new level. And with $7 trillion under management, Blackrock has a powerful voice and an ability to influence corporate behavior.

Citing the hazards of rising temperatures, the need for smaller carbon footprint, and how sustainability factors are linked to long-term economic growth, Fink's letter highlighted the investment risks presented by climate change. The letter also outlined a firm-wide commitment to consider ESG factors in all facets of the organization, from active management, portfolio construction, and product design to company engagement. Blackrock plans to expand its ESG product offerings, move away from heavy polluters such as coal in its active strategies, and offer new fossil-free funds. Fink's letter also included a renewed promise to actively support these principles via shareholder engagement and proxy voting.

While environmentally focused organizations are cheering Fink's leadership and actions, others deem his approach to be flawed. Viewing ESG managers as pushing social issues and agendas that should be decided elsewhere, opponents to Fink's position believe that companies should focus on factors clearly linked to profitability and nothing else.

Regardless, the impact of climate change is being felt near and far, the trend toward sustainability is strong, and the evidence that it makes a difference is growing. We submit that if companies don't take it seriously, climate change may in fact affect your investment portfolio — and not in a good way.

For more information, please contact your Key Private Bank Advisor.



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