# Analysing net-zero targets and understanding physical risk

In late October, **Tell Media Group**, in cooperation with **BMO Global Asset Management**, **Federated Hermes** and **JPMorgan Asset Management**, invited Finnish investors to discuss climate change risk and opportunities. Tell Media Group founder Niklas Tell and FBNW editor Janina Sibelius moderated the roundtable.

By: **Niklas Tell** Photo: **Christer Salling**

The discussion started out with Janina Sibelius asking the investors how they have been working with climate change from a more strategic portfolio perspective.

**HANNA KASKELA:** "Varma introduced a climate policy for investments in 2016 and this was renewed in 2019 where we extended the policy to cover every asset class. The overall aim is to be carbon neutral by 2035, which is also a goal for the Finnish government. We have specific targets for listed equities and bonds on cutting the carbon intensity and a roadmap for how to get there. Then we're also trying to figure out who the beneficiaries will be going forward, which is sometimes missing in these discussions."

**MIKA LESKINEN:** "It's a little bit different for us as a fund company as we don't have one single portfolio but several different ones. I therefore find it a little bit difficult to say that by 2030, our CO2 emissions will be 30 per cent below the current level because if we were to set a target like that, it could limit our product development in areas where emissions are higher. That's just one aspect. We have mainstream products where we tackle climate change through ESG integration and we also exclude stocks like mining companies if the share of thermal coal is above 20 per cent of revenues. That threshold will be lowered to 15 per cent by the end of 2022 at the latest."

**ANNIKA ESONO MANNINEN:** "For us, there are, of course, similarities with what has already been said. Our overall goal is to be net zero by 2050 the latest. We also look for managers that use bottom-up research to steer portfolios in the right direction, even if we also have certain limits and exclusions, for example on coal. For a long time, we've been able to do carbon analysis on a certain part of assets and we're working on how to widen that to cover everything in order to work with our clients and understand what type of products can help us and our clients in reaching carbon neutrality."

NIKLAS TELL: WOULD YOU SAY THAT IT USED TO BE THAT IF YOU FOCUSED ON THE "G" IN ESG, THEN THE "E" AND "S" WOULD PROBABLY BE OK? HAS THAT CHANGED AND ARE YOU NOW FOCUSING ON THE "E" FIRST?

**CAROLINE CANTOR:** "We have an engagement team at Federated Hermes that provide stewardship and engagement services to a number of the largest pension funds and institutional clients. Initially, a lot of the engagement was around governance topics, but we're now changing our framework because we think having good governance is the basic standard you need to have in place to be able to have true engagement around other topics. In that sense, encouraging good governance is a necessary step to be able to engage effectively on other significant topics, like the approach to climate change. For example, we encourage things like senior management remuneration being linked to environmental and social improvements.

**VICKI BAKHSHI:** "We survey our engagement clients every year to ask about their top priorities and consistently over the past two or three years, climate has risen to the top of that survey. It's definitely the issue of main concern for our engagement clients, as well as a topic of many of the questions coming in from our fund clients. I think, however, that there's an increased focus on the governance aspects of climate change. We incorporate climate change systematically into our voting processes and we use our voting as a tool to engage on climate change. So we're sort of bringing the 'E' and the 'G' much closer together."

**JENNIFER WU:** "The way we think about climate has evolved over time because climate risk is investment risk. Also, climate change is not only about transition risk. It's also about physical risks. If you think of the 'S' in ESG, Covid was a great example of this. Companies that were good at taking care of their employees fared pretty well compared to some of those that didn't and I think it's the same with climate. With more extreme weather events, you need to consider where your employees are located and their commute to work. We're starting to have conversations about how companies are managing these climate related risks. Regarding the governance aspect, I very much agree with what Vicki said. We're not only looking at the diversity of the board in terms of gender but also if they actually have the expertise to manage these risks. So for us, climate change is not isolated in the 'E' but it basically cascaded across ESG."

**ANNIKA ESONO MANNINEN:** "I do think that portfolio managers look at ESG differently today. It used to be that 'G' was the only thing that mattered and if that was ok, everything else was assumed to be ok. However, with big themes such as climate change, portfolio managers must focus on that to see how a company performs on that measure."

**HANNA KASKELA:** "Scandinavian investors have been thinking about these things for a very long time and it started with us excluding some industries, such as controversial weapons and tobacco. From there, we have moved on but governance has always been a part of it as we've realised that there are huge risks if the governance structure is poor. That applies to the 'S' and the 'E' as well. When it comes to the 'E' specifically, it's more than just climate change. It also relates to biodiversity and how we actually use nature. For example, we want to electrify the transport sector but what does that mean when it comes to land use? Is cobalt mining in Congo ok? Today we need to think about more things and it's no longer just a tick-the-box exercise. There are a lot of so-called grass root investigation that needs to be done."

**JENNIFER WU:** "How difficult or how easy do you find that? We find it very difficult to quantify these and even the companies we talk to sometimes have difficulties and might say that they're building this railway and have some idea about the impact and potential land use, but don't have the full spectrum. What's your experience?"

**HANNA KASKELA:** "I guess when it comes to biodiversity, things are happening and we're learning how we could think about these issues but it's not easy. We've done some work on this for individual companies but it's difficult on a portfolio level as comparability is difficult. It's moving in the right direction but we're not there yet."

## PARTICIPANTS

- **ANNIKA ESONO MANNINEN**
  *Head of ESG at OP Asset Management*
- **MIKA LESKINEN**
  *Chief investment officer at S-Pankki*
- **HANNA KASKELA**
  *Director of responsible investment at Varma*
- **VICKI BAKHSHI**
  *Director, governance and sustainable investment team at BMO Global Asset Management*
- **CAROLINE CANTOR**
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**MIKA LESKINEN:** "I think the learning curve when it comes to biodiversity will be very fast because we can utilise many of the concepts we've used for climate change in general. But back to the original question if 'E' is the dominating letter in ESG right now and I think it is. If I look at this from a portfolio manager point of view, it's a question of which issues are affecting the asset pricing and today that's climate change. Either in a positive way because you're investing in a company that's providing some solution for the problem or in a negative way if you own operations that are very energy intensive."

NIKLAS TELL: THE DIFFICULTIES IN MAKING COMPARISONS WERE MENTIONED EARLIER. IS REGULATION THE ANSWER?

**MIKA LESKINEN:** "Regulation will not help us in defining the companies that are more environmentally friendly. I'm afraid it will only create more confusion. At least until methodologies and reporting frameworks are developed further."

**JENNIFER WU:** "I don't think regulation can solve these problems for us. For example, we recently looked at avocado companies. But growing avocado requires a lot of water and then there are problems with cartels and money laundering at Mexican avocado farms. If you were to use the EU taxonomy and SFDR, where would you put such a company? Is avocado good or bad? A lot of times things are not that clear cut. Say you have a company in the energy sector that's transitioning. They're in a bad sector but they're the good guys in that bad sector. How do you explain that to the general public in a clear-cut way?"

**VICKI BAKHSHI:** "It's so common to have companies that are strong on ESG in some aspects and weak in other aspects. I do think regulation and labels are important in that it brings everyone to the same level in terms of data and consistency. However, when we report on our funds, I think we need to split out as much as possible and explain the different impacts. How does this look from a climate perspective, a social perspective and a governance perspective? When we can get into trouble on ESG is when you try and crunch too much into a single metric or a single data point."

**CAROLINE CANTOR:** "I think some regulation can be beneficial. Especially regulation around funds and companies that encourage more reporting. If we have data, then we can start to compare and see how they evolve over time. Also, if you're seeking to invest in companies that are providing solutions to climate issues, regulation can help moving consumer habits into using recyclable products, for example."

NIKLAS TELL: JENNIFER MENTIONED THE AVOCADO PROBLEM AND WE ALSO HEARD ABOUT COBALT MINES. GIVEN THE FOCUS ON ESG, IS IT EVEN POSSIBLE TO DO THE RIGHT THING AS ALMOST EVERY COMPANY MIGHT HAVE ASPECTS THAT ARE QUESTIONABLE FROM SOME ESG ANGLE?

**JENNIFER WU:** "I think the problem is that people are looking for simple solutions and especially retail investors don't necessarily have a lot of time to read the very detailed reporting on these issues. They want an easy answer if this is light green or dark green and if you simplify stuff like that, then it runs the risk of greenwashing. With professional investors, it's different because they have the time and resources to break things down to understand the details but communication to the broader audiences is really hard."

**MIKA LESKINEN:** "Also, it seems that, at least initially, the SFDR categorisation into Article 8 and 9 varies a lot. I've seen products advertised as Article 9 that I can't even imagine being Article 8 funds. That's another source of confusion going forward."

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> *– Annika Esono Manninen, OP Asset Management*

NIKLAS TELL: JENNIFER, YOU MENTIONED PHYSICAL AND TRANSITION RISKS EARLIER. ARE THESE VERY DIFFERENT AND WHERE DO THEY MEET?

**JENNIFER WU:** "There's definitely a relationship between the two and at this stage, I think you want to make sure you're capturing both. There's a lot of focus on transition risks but I don't think there's sufficient research into physical risks. We spend a lot of time on this and think about it as we allocate capital to different countries. I don't think you can do asset allocation without thinking about physical risks these days – especially given how frequently extreme weather events are happening. I don't see people doing it systematically, partly because it's hard. I do, however, think that it's possible to have a framework that gives you a ballpark idea of physical risks by country. Then you bring it all the way down to the individual company and look at the location of their operations. You can't look at climate and purely focus on transitional risk or physical risk. You need to keep an eye on both aspects."

NIKLAS TELL: HANNA, HOW HAVE YOU LOOKED AT PHYSICAL RISK AND IS IT SOMETHING YOU INCLUDE IN YOUR ASSET ALLOCATION DECISIONS?

**HANNA KASKELA:** "I think it's easier if you look at it on a case-by-case basis than on the whole portfolio. We've looked at it for our real assets and our direct real estate portfolio but it's difficult."

**ANNIKA ESONO MANNINEN:** "I agree. It's easier to analyse and price transition risk compared to physical risk. Just understanding the assets of a company is not as straightforward as you might think and if you don't have all the data, you don't get the full picture when you're trying to price the physical risk. As mentioned, it will depend on the industry and there are naturally bigger physical risks in some industries compared to others."

**VICKI BAKHSHI:** "One reason why calculating exposures to physical risk is complex is because there are multiple types of physical risk and you need very granular data about location. So I agree that there's quite a data crunching challenge but I do see that data can help identify some of the companies that are potentially most exposed. But we must not forget about the second aspect, which is how well the company is managing the physical risk and here you really need to do deeper analysis and engagement. Another issue that we talk about is mitigation. Since energy systems in China and India, for example, use a lot of coal, industrial companies in these countries will look like they're more energy intensive than those in Western Europe. With investors and asset managers having emission reduction targets, there's a risk of pulling capital away from emerging markets just at the time when companies need the capital to invest in decarbonisation."

NIKLAS TELL: IS THERE A CONFLICT BETWEEN WANTING TO REDUCE CARBON IN THE PORTFOLIO AND AT THE SAME TIME WANTING TO HELP COMPANIES AND COUNTRIES TO TRANSITION TO SOMETHING BETTER?

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**ANNIKA ESONO MANNINEN:** "It depends on how you go about this. If your focus is to help companies to reduce their emissions, then emissions are reduced at the portfolio level as well. Another way to reduce the carbon intensity of your portfolio is, of course, to simply cut high emitters from the portfolio but that will not necessarily lead to any change in the real world. It's a good question. What does it mean to half carbon emissions? How are you going to do that? Being invested in a low carbon fund doesn't necessarily mean that your money is leading to any change in the real world."

JANINA SIBELIUS: DO YOU THINK THERE'S A REAL RISK OF MONEY FLOWING OUT FROM GEOGRAPHIES WHERE IT'S NEEDED BECAUSE INVESTORS WANT TO BALANCE THEIR PORTFOLIOS TOWARD SOMETHING THAT'S MORE SUSTAINABLE OR GREENER?

**MIKA LESKINEN:** "I actually think that if money is running away from a certain area or from a company, that should be a wake-up call for that area or company to act and change. I see exclusions having a similar effect to speed up things. Not a single CEO of a company will be unaffected if more and more investors are unable to invest in that company."

NIKLAS TELL: I ASSUME IT ALSO DEPENDS ON THE TIME FRAME. EVEN IF A COMPANY IS ON THE RIGHT PATH, IT MIGHT TAKE TIME BEFORE THEY HAVE REACHED THE TARGET AND INVESTORS MIGHT NOT BE WILLING TO WAIT THAT LONG DUE TO REPUTATIONAL RISK.

**JENNIFER WU:** "On the one hand, we're under a lot of pressure from the market, media and clients to show commitment and reduce our emissions by X per cent within the next eight years. On the other hand, we must recognise that we're working with a number of companies that are transitioning and for them to get to that target, it may take more than eight years. It may take 12 years or 15 years. So I think the timing mismatch is a real challenge that we're facing right now as investors. And it's difficult to explain to an external audience."

**MIKA LESKINEN:** "I think the problem is that there's a lot of information available about our approach to ESG but unfortunately, I think extremely few retail investors have actually read it. Most think that ESG means everything is ok, there are no controversies and there are only sunny companies in the portfolio. When there's a press article that you've invested in company X, you have all the comments about greenwashing and things like that."

**ANNIKA ESONO MANNINEN:** "I agree with Mika and that takes us back to the question on exclusions because there are really high expectations, especially from retail clients, when it comes to the impact of exclusions and a lot people argue that's the way to go. But when I read the academic literature to see if this is something that has an actual impact, it's less clear-cut. It's signalling but there's no proof that the signal actually has worked, so the link is very indirect."

**VICKI BAKHSHI:** "We support engagement and we want to change companies but I think there has to be some kind of carrot and stick and there's a point at which we want to divest as a signal. In the fossil fuel production industry, we've got a small number of examples of companies that genuinely have made that transition and others that are promising to make that transition. The big question is if they will genuinely change from being fossil fuel companies to becoming energy companies. Are they really willing to make that shift and are the promises they're making now credible enough and how can we really hold them to account?"

NIKLAS TELL: COMING BACK TO THE CORE QUESTION OF CLIMATE RISK AGAIN. CAN YOU DO CLIMATE RISK ANALYSIS ON ASSET CLASSES OR DO YOU NEED TO GO INTO INDIVIDUAL NAMES?





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> *– Mika Leskinen, S-Pankki*

**ANNIKA ESONO MANNINEN:** "When I speak with our analysts on the allocation side, they're able to do some modelling but there are still issues and one of the biggest is the high variability between companies, which makes it difficult to start from top-down."

**MIKA LESKINEN:** "Obviously, there are sector-specific issues that can help you but at the end of the day, you need to go down on the company level."

NIKLAS TELL: WHERE DO YOU SEE THE BIGGEST CHALLENGE WHEN IT COMES TO ASSESSING CLIMATE CHANGE RISKS?

**HANNA KASKELA:** "If you think about transition risk, one way forward is to assess how much you've invested in certain industries. We've done this since 2018 and then it doesn't matter if it's equity investments, corporate bonds or private markets. Then you do more hands-on research on the companies within those industries that face political or regulatory risks, such as increased emission right prices. If you have a chemical company that's a provider to the oil sector, the revenue prospect may not be that great. But being a provider of some sustainable product on the consumer side might actually create more growth prospects for that company."

**CAROLINE CANTOR:** "When it comes to analysing industries, we're getting quite a lot of client questions regarding how many companies in our portfolios have net-zero targets. I think that's because it can be used as a tick-box exercise from an investors point of view and a way to make a judgement on a portfolio. We would caution on this as simplistic data can be misleading. For example, one of our analysts was looking at the cement industry, which clearly is a high emitter, and yet a lot of these companies have set net-zero targets. They don't necessarily have the proper solution for how they actually can get there but they have ticked that box. That's why you have to do more detailed reviews of the individual companies within cement manufacturers and find those with a real vision and plan of how they can use different technologies to reduce their emissions."

**VICKI BAKHSHI:** "I agree with the point that counting the number of companies with net-zero targets isn't enough. We're collecting a whole range of data points on companies' net-zero alignment from a whole range of data sources. We try to look not just at the overview of ambition but also whether there are shorter term targets, how ambitious those short-term targets are and then combining those data points to try and get a rounded picture of a company's net-zero alignment. Also, picking up on the points

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> *– Jennifer Wu, JPMorgan Asset Management*

about cement. There’s much more guidance now being developed by investors to try to understand what best practice really look like, which is pretty important so we can be more consistent when we engage with companies.”

**JENNIFER WU:** “I think one of the biggest challenges is how interconnected we are. It’s not like we’re able to investigate a company’s climate risk exposure in an isolated world. You could just look at a grocery chain store in Finland and you will find that it will source cookies and all kinds of things from everywhere around the world. What’s the commitment there to decarbonise? What’s the physical risk on supply chain logistics? It’s impossible for a portfolio manager to understand all of that and become an expert. It’s extremely hard because we’ve never really done that before but I don’t think it’s impossible. Just like ESG, I think it will become part of what you do as an investor and over time get to understand interconnectivity better. But that’s the biggest challenge.”

**NIKLAS TELL: IF YOU LOOK AHEAD, WHAT’S ON YOUR WISH LIST WHEN IT COMES TO THE DEVELOPMENT IN THIS AREA?**

**ANNIKA ESONO MANNINEN:** “I have a very long wish list. First of all, I would like there to be an understanding that responsible investing or ESG is not one thing. Different people at different organisations have very different styles and different methods they can use as well as different goals they want to reach. At the moment, a lot of times when the media is talking about ESG investing, they tend to write about it as this one thing but when you read the article, you realise that it’s all over the place. It’s a little bit about value-based exclusions, then a bit about impact and then about ESG integration, which can mean so many different things. An understanding that it’s not something that can be simplified too much or something that can be defined in a straightforward manner would help move things forward.”

**MIKA LESKINEN:** “Finsif was introduced some 11 years ago and in the opening panel discussion, I said that I hope we don’t need to speak about ESG in 10 years’ time because it will just be part of investing. We’re not quite there yet so maybe I can renew this wish now.”