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Climate Change: Identifying Future Makers and Future Takers

by David W. Richardson, CFA®, Managing Director, Global Head of Marketing and Client Services, Impax Asset Management (U.S.)

For those investors wondering whether and how climate change might affect their investment portfolios, Mercer, the global consulting firm, has an answer. Mercer's recent report, *Investing in a Time of Climate Change*, advises:

"Climate change is an environmental, social and economic risk... investors cannot therefore assume that economic growth will continue to be heavily reliant on an energy sector powered predominantly by fossil fuels. This presents asset owners and investment managers with both risks and opportunities."

The importance of this document, and its timeliness, cannot be overstated. Investment consultants such as Mercer advise the world's institutional investors on what to invest in and where, which risks to focus on, and how they might best manage them. They are the gatekeepers between trillions of dollars of investment assets and the managers who compete to manage those assets. Building on their 2011 report on climate policy risk, Mercer has boldly plunged into the climate change debate advising their clients that it is real, it is here, and it will affect their portfolios. These findings reinforce what Impax Asset Management has been advising our clients for many years: climate change will materially impact investment returns, and the time to address that risk is now.

The report details four potential outcomes for climate change scenarios. The best case scenario, a 'Transformation Scenario' where climate change is somewhat contained, would likely result in negative impacts to returns derived from developed market equity and private equity. The worst case, a 'Fragmentation (Higher Damages) Scenario,' where long-term weather patterns

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KEY TAKEAWAYS

- In their recent report titled "*Investing in a Time of Climate Change*," Mercer has boldly plunged into the climate change debate advising their clients that it is real, it is here, and it will affect their portfolios.
- The report details four potential outcomes for climate change scenarios. The best case scenario, a 'Transformation Scenario' and the worst case, a 'Fragmentation (Higher Damages) Scenario'. In between these two scenarios any combination of negative impacts may be experienced.
- Industry sectors that are particularly sensitive to climate risks—such as energy, utilities and materials—will require detailed attention. Investors will need to identify and retain different managers whose expertise covers climate issues and to learn to assess performance against new benchmarks.
- The Mercer report concludes with an observation that, when it comes to climate change, all investors are 'future takers'—they will all feel the effects on returns of whichever climate change scenario comes to pass.

are disrupted, will negatively impact returns from agriculture, timber, real estate, and emerging market investments. In between these two scenarios any combination of negative impacts may be experienced.

The report states that the effects of climate change will be "most meaningful" at the industry-sector level. So, for example, it compares the likely impacts on the coal sub-sector versus the renewables sub-sector, suggesting that the average annual returns from the coal sub-sector could fall by anywhere between 18% and 74% over the next 35 years, while the renewables sub-sector could see average annual returns increase by between 6% and 54% over the same period. These are huge risks that the average fund is not being compensated to take!

Importantly, industry sectors that are particularly sensitive to climate risks—such as energy, utilities and materials—will require detailed attention, attention that is likely to be outside the scope of a typical investment committee's expertise. This, in turn, will require investors to identify and retain different managers whose expertise covers climate issues and to learn to assess performance against new benchmarks. Again, the importance of this cannot be overstated. Mercer is urging clients to make a sea change in how they address the threats to their portfolios posed by climate change—a change in both who they hire to manage their investments and how they assess investment performance.

It is important that one of the world's largest investment consultants has leapt into the debate on climate change and its effects on investment portfolios with reasoned analysis and actionable recommendations. We are gratified that the report provides objective support for our investment approach. For 18 years we have been advising our clients that the effects of climate change policy and physical climate impacts—both negative and positive—will be highly differentiated between sectors and within them. While the energy sector may see the most pronounced effects, other sectors—from agriculture to pharmaceuticals—will all see profound impacts. Investors need to develop, or access, an in-depth understanding of how these effects will translate into shareholder value—and ensure that they are not carrying uncompensated climate risk within their portfolios.

The report concludes with an observation that, when it comes to climate change, all investors are 'future takers' - they will all feel the effects on returns of whichever climate change scenario comes to pass. Alternatively, Mercer defines 'future makers' as the emerging group of investors and managers that feel compelled by the magnitude of the climate change challenge to try to influence which scenario transpires. Acknowledging the scientific consensus on climate change, and recognizing the threat it poses to long-term investment returns, these investors will both invest in line with the science, and encourage policymakers and businesses to take appropriate action.

Impax is firmly within the definition of 'future makers.' Over the coming years, as the battle against climate change intensifies, it is likely that the ultimate beneficiaries of the world's pension funds and insurance companies will increasingly want to know whether their prosperity is in the hands of future takers, or future makers.

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Pax World Global Environmental Markets Fund

The Global Environmental Markets Fund's investment objective is to seek long-term growth of capital. The Fund invests in environmental and resource optimization markets and seeks to take advantage of rapidly accelerating global demand for efficiency solutions in the areas of energy (alternative energy, energy efficiency); water (infrastructure, technologies and pollution control); waste (waste management and technologies, environmental support services), and sustainable food, agriculture and forestry.

Pax World Management LLC

Pax World is a leader in sustainable investing, the full integration of environmental, social and governance (ESG) factors into investment analysis, security selection, portfolio construction and risk management. Pax World combines rigorous ESG analysis with equally rigorous financial analysis in seeking to identify better-managed, industry leading companies that meet positive corporate responsibility standards, have a clear vision for managing risk, and are focused on delivering long-term value to shareholders. Pax World launched the first socially responsible mutual fund in 1971 and today offers a family of seven mutual funds, ESG Managers® Portfolios, multimanager asset allocation portfolios powered by Morningstar Associates, LLC, and separately managed accounts. For more information, visit paxworld.com.

Impax Asset Management Ltd.

Impax Asset Management Ltd, sub-adviser to the Pax World Global Environmental Markets Fund, is a leading global equity specialist, investing in companies active in the rapidly growing and inefficiently priced resource optimization markets. Impax has been researching and managing portfolios of publically traded stocks and private equity in this space for over 17 years, with 27 investment team members. Impax has offices in London, New York, and Hong Kong.

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