Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Financing Climate Change

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | FEBRUARY 2020

Bank regulation may force the economy to shift towards a less carbon intensive model more quickly than expected. Some enterprises will flourish in this environment and others will fade, potentially leading to material shifts within the indices. As the market does not currently price for this, a solidly embedded environmental, social and governance (ESG) approach, as we believe we have in our strategies, may become a crucial differentiator for long-term performance.

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If Google Trends is to be believed, interest in ESG investing has increased tenfold since 2017. In Europe, the share of ESG funds has almost doubled to 7%.[1] This rapid development has overshadowed another major ESG-driven shift in financial markets, one that may have an even more significant and more imminent impact on the behaviour of companies and their share prices.

In December 2019 the European Commission announced its 'Green Deal'. The Commission states that 'the private sector will be key to financing the green transition', and that 'long-term signals are needed to direct financial and capital flows to green investment and to avoid stranded assets'.[2] Amongst other things they say that 'climate and environmental risks will be managed and integrated into the financial system. This means better integrating such risks into the European Union (EU) prudential framework and assessing the suitability of the existing capital requirements for green assets.'

"Banks will have to integrate ESG risks in general, and climate change risk in particular, into their risk management process"

[1] Source: Bank of America

[2] Source: European Commission, 'The European Green Deal', 12 November 2019, available at https://ec.europa.eu/info/sites/info/files/european-green-deal-communication_en.pdf

When put simply, what these cryptic words mean is that banks will have to integrate ESG risk in general, and climate change risk in particular, into their risk management processes. For example, banks will have to assess the flood risk of a property in their mortgage risk assessment, under the assumption that worldwide temperatures rise by 2°, 3° or 4° centigrade. Even more difficult than these physical risks are the transitional risks, such as the risk that certain carbon intensive assets such as coal-fired power stations, cement plants or gas pipelines, have to be written down due to regulatory change. On the flipside, migrating towards a carbon neutral economy by 2050 will require material investments, most of which relates to reducing carbon emissions from buildings (e.g., insulation, heating/cooling, construction materials etc.).[3] In the recent calculation based on the EU taxonomy of environmentally sustainable activities, the investment gap is about €270 billion annually or €2.7 trillion over the next 10 years, equal to 15% of EU GDP.

"The European Banking Authority is developing a dedicated climate change stress test to quantify vulnerability to climate change risk"

The European Banking Authority (EBA), which manages the banking stress test in Europe, will run a sensitivity analysis for climate change with a number of volunteer banks in the second half of 2020. The EBA will develop a dedicated climate change stress test to quantify the vulnerability to climate change risk[4] at a not yet specified date. Christine Lagarde recently suggested this could be as early as 2021. The stress test is likely to feed into the assessment of the individual banks' capital requirements set by the regulators, namely the European Central Bank.

Europe is not alone. The Network for Greening the Financial System (NGFS) was founded in December 2017. This global network of supervisors and central banks includes amongst others the People's Bank of China, the Bank of Japan and the Bank of England. It aims to mobilise the financial system to manage climate and environment-related risks and scale up green finance to support the transition towards a sustainable economy. In its first comprehensive report, published in April 2019, the NGFS called for collective action and reasserted climate change as a source of financial risk.

As banks recognise the physical and transitional risks in their calculations for probability of default, valuation of collateral and capital ratios, they will have to materially increase capital allocations to 'brown' loans (i.e. non-green loans). At the very least this would lead to an increase in the pricing for these facilities, but given risk limits and the impact on the overall capital ratio, it may mean that banks will simply have to refuse credit entirely. For instance, there are already a number of banks who have a blanket ban on the funding of coal mining and coal-based electricity generation.

The Commission has recently published a further draft of its Taxonomy, which is a detailed list of economic activities that help mitigate carbon emissions. Going forward there are suggestions to apply capital relief to those activities considered helpful while applying higher capital requirements on activities considered detrimental. If implemented this would create a double whammy for the financing of 'brown' activities as the banks would apply both higher risk weighted assets and higher capital ratios to these loans. Such a direct intervention in capital flows has more than a faint echo of the *dirigiste* planned economy models of the 1970s.

"Credit tends to be a more immediate driver of company behaviour than equity. Companies that cannot fund their projects will have to change course."

So why is that relevant for our portfolios which have either no position in banks at all or usually a material underweight? The point is that credit tends to be a much more immediate driver of company behaviour than equity. As companies only rarely tap the equity markets to fund their strategic priorities, CEOs can, and many do, ignore ESG-focused equity investors for a long time, in particular when more and more of their shareholders are passive funds. It is very different when it comes to loans and bonds however, meaning companies that cannot fund their projects at a reasonable price or worse, cannot access credit at all, will have to change course.

With credit capital drying up for carbon-intensive industries and flows directed towards activities that either generate positive carbon outcomes or are carbon neutral, earnings and capital returns will shift, leading to a rebalancing of the economy and the equity indices. Staying abreast of these developments requires an active and ESG-focused approach.

[3] Source: EU Technical Expert Group on Sustainable Finance, 'Taxonomy Technical Report', June 2019, available at https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-taxonomy_en.pdf

[4] Source: EBA Action Plan on Sustainable Finance, 6 December 2019

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. Stocks of **small-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

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CRC 2994686 Exp. 03/31/2021 9817211_KC_0320
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