The Big Interview:

Nabeel Abdoula on Climate Change and the use of Implied Temperature Rise metrics.

COP26 saw an even greater focus from many countries across the world to actively tackle Climate Change. From an investment point of view, one of the debates that repeatedly comes up in relation to this is reducing the carbon footprint in your portfolio. This invariably means using backward-looking metrics but more recently, the use of forward-looking metrics such as Implied Temperature Rise (ITR) has been increasing.

Nabeel Abdoula, Deputy Chief Investment Officer, answers questions around the theme of Implied Temperature Rise Metric (ITR) and how it might be a better solution to creating a climate-aligned portfolio rather than relying on historic carbon emissions data. We investigate and discuss whether we should be using historic data at all, the role of a science-based approach in setting our investment strategies and key developments over the last 18 months around the appropriateness of data.

Q:

Does the Fulcrum Climate Change Fund primarily invest in companies that are already aligned to climate change or does it seek out companies and sectors that are not currently well aligned in order to try and make a difference?

A:

It is true to say that we are mostly invested in companies where their policies and commitments are already aligned to addressing climate change. However, it is not about reducing/minimising our carbon footprint. Indeed, the carbon emissions of the portfolio will typically be higher due to some areas we own such as solar and wind. This is because of the current production cycle – building solar and wind farms uses a lot of carbon to do so.

The other key difference is that we identify companies that are in sectors that are not typically part of climate change funds. This is a big differentiator for Fulcrum. For example, we are investing in companies across all the sectors including the best tech, energy and utility companies - so it is not just about focusing on one area.

If you think about the focus on climate change so far, it has really been devoted to supply and energy transition. However, it is just as important that highly commoditised businesses (such as supermarkets for example) are also rewarded for their efficiency of carbon use as well as gas, oil, coal, wind and solar companies where valuations are already apparent. Every company in every sector needs to transition if we want to align.

Q:

How confident are you in the data being used to construct climate aligned portfolios? Can a quantitative (data) driven model (i.e. in the form of an ETF) be entirely relied upon when it comes to portfolio construction or is the qualitative research an essential overlay?

A:

Personally, I do not think the data sets are ready to be entirely trusted on everything – some of it is selectively self-disclosed, some of it is unreliably estimated. Over the last 3 years we have been actively engaging with the data providers and we have seen significant evolution in this area.

The data is not static; it is constantly evolving. I get concerned when I see ETFs being constructed purely on the basis of the data in this area. Don't get me wrong – ETFs are extremely useful tools in portfolio construction but only when the rules of the game are known and stable.

In addition to the data that is available we use our datasets as a filtering mechanism. We commit to being below those 2-degree benchmarks but beyond that, we perform qualitative analysis on each individual company to help to understand that the commitments and historical assessments are in fact what they say they are. For example, when it comes to estimating which climate change scenario a company's strategy is aligned with, we have often disagreed with the temperature that our data providers have given us on a company. Where this has happened, we have engaged with these companies and asked more specific questions in relation to their data and they have subsequently changed their own metrics.

This reminds us that the data must always be fully scrutinised, making this dynamic feedback loop a very productive one. As a result, we believe our fund to be more climate-aligned than a typical equity portfolio or the more traditional indices. Importantly, we do this by assessing all companies' alignment, across all sectors, rather than just reducing exposure to energy. We do not agree in simply tilting portfolios towards climate objectives by a certain percentage. If you are going to tackle climate change it needs to be done fully so that at least some tangible difference can be made.

Q:

How do you marry applying subjective judgement to the likelihood of individual companies meeting their targets and relying on third-party data? Linked to that, do you make a judgement on whether an individual stock is a good investment, regardless of climate effect?

A:

The data filters are applied to the universe, so it is effectively the 'sandbox' or testing environment from where we start our investment process. Absolutely, if there are aspects of the data that we think are not appropriate then we want to improve the data. Engaging with data providers is an essential part of what we are doing. Beyond that, our stock selection process, specific to Fulcrum, is thematic and fundamental. The reason for this is that we are not yet 100% confident that a 'quantitative data-only' portfolio would not be susceptible to uncertainty. You would then want to have an additional overlay on it to ensure and confirm that the data represents something that reflects the effort the company is making.

Q:

Coming back to one of your earlier points about "investment" vs "consumption" – is the data missing the concept of amortising the carbon usage over its useful life?

A:

The measurement of absolute emissions tends to focus on a company's operation and energy use (so-called Scope 1 and 2)- which makes a wind company high-carbon because of its production process. So, understanding where companies sit it in the broader supply chain – including, where relevant, the emission behaviour of suppliers and consumers (so-called Scope 3) – is essential. Investors need to understand this topic, rather than picking any data point as a solution. Ultimately, all data points and all data issues will have pros and cons. The key is understanding the science and hence the mapping of the science to the data is essential.

Q:

You talk of the concept of "transition alpha" for climate-aligned companies. What are the conditions/ outcomes that will make this transition alpha emerge and what risks are there?

A:

There are two scenarios under which the repricing happens; one is linear, and the other is non-linear. The linear path is the least disruptive path and relates to financial analysts recognising that climate considerations are essential to assessing the quality of a company and hence pay increased attention to the impact of their investments.

In turn, that increases the allocation (and the valuation) of climate change companies relative to other companies in the same sector. This is no different to the pricing in of any other themes. For example, using tech disruption as an example, if you have an approach that identifies and uses technology in your business in a better way relative to your peers, your company will trade at a higher valuation with everything else being equal. A similar scenario occurs for climate- as the preference towards climate alignment goes up, the reward for being aligned goes up.

The second mechanism is the non-linear one: namely that we do not do anything about climate change until action becomes inevitable, and regulation tightens against the "climate offenders " and the penalty leads to a very dramatic repricing.

In summary, either the private sector helps the funding channel work through the funding of capital, or the regulators step in and increase the cost of doing business in a non-aligned way.

Q:

Picking up the concept that tilting is not sufficient, how concentrated is the Fulcrum portfolio? Assuming it is active with high conviction, how can an investor align a complete portfolio in a cost-efficient way?

A:

In our opinion, the beauty from a portfolio construction perspective with the ITR metric is the ability to create diversified global equity portfolios that you can use to allocate a meaningful proportion of a portfolio's overall capital to, as opposed to a more concentrated portfolio which brings about more idiosyncratic risks.

For example, we have built a global equity portfolio that is diversified across countries and sectors with a 5% tracking error to the MSCI ACWI. Hence, it is very different in composition to the MSCI ACWI but it remains diversified, with more than 250 stocks in the portfolio.

Allocating to a globally diversified climate-aligned fund as opposed to a more concentrated bottom-up stock-specific fund, you are able to increase the impact by a far greater proportion. By way of example, reallocating 1 per cent from a global equity portfolio that is 3^{o}C-aligned to a concentrated portfolio which is climate aligned can reduces the overall temperature by 0.02^{o}C. However, reallocating 10 per cent to a globally diversified portfolio can reduce the overall temperature by 0.1^{o}C; a five times greater impact.

So, having diversification to increase an overall allocation increases the impact.

Q:

Pension fund trustees are now focusing a lot more on stewardship i.e. active voting and influencing management decisions – it would be interesting therefore to get some comments from Fulcrum on Stewardship.

A:

Effective stewardship is fundamentally important. Our team engage with all relevant companies on this matter, and beyond that we also engage with a number of data providers. Being an investment boutique, Fulcrum does not have the ability (like some of our larger counterparts) to influence the board via our voting rights and so what we do is seek to influence with our ideas and innovation. We seek to have actual conversations on SBTi with companies to share our ideas, what we think and why.

So, for us, stewardship, goes beyond engaging with management (which we do) but also engaging other key parties in our industry, as well as collaborating with peers (in organisations such as Climate Action 100+). For us, innovation typically comes from smaller players because we can take such risks – it may be that we are willing to and have more courage maybe. For example, the courage to move away from the market if the market is misaligned.

Q:

If tilting is not enough, as most sectors are mis-aligned and big steps are needed then, do we need to rethink the purpose of tracking error?

A:

Less than a third of listed companies are currently aligned to a below 2°C outcome. This raises the philosophical problem of how to think about diversification in the context of a misaligned market. One advantage of implied temperature rise (ITR) metrics is that they can help us tackle this challenge, analytically, whilst also being easy to communicate.

You can speak to people about a temperature, and the gap between where companies are and the destination. It doesn't necessarily need to involve the understanding of scopes of emissions, 'weighted average carbon intensities' and anything other than a "temperature".

Ultimately, we hope the message comes through clearly; tilting is not enough. You can build globally diversified portfolios that have a real impact and ultimately what we are trying to do here is solve the long-term problem. We think the more people that allocate a greater proportion to this area then the more chance we will then have of solving the issue.

This interview was conducted as part of the Pensions for Purpose, Paris Alignment Forum webinar on 8 Sept 2021. Remarks have been adapted and edited for the purposes of this piece

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