PGIM FIXED INCOME

Where Climate Meets Global

Webcast Transcript

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Edward Farley, Head of European Investment Grade Corporate Bonds: Hi, morning. My name is Ed Farley. I'm the Head of European Investment Grade Corporate Bonds. Today I'm joined by Armelle, our Co-Head of ESG Research, and we're going to discuss climate, and in particular within -- or how you frame this within corporate mandates. We're going to look at the traditional ways of looking at climate, some future ways of looking at climate, the impact of the regulators, etc. But to start with, I was hoping that Armelle would describe why are we looking at climate itself.

Armelle de Vienne, Co-Head of ESG Research: Yeah, absolutely. Thanks, Ed. I think the first question is, why are we thinking about climate now? And I think a lot of that stems from previous conversations were much more theoretical and maybe more academic, but they're becoming much more realistic today. Globally, we've seen the implications of climate change. So far, 2024 is turning out to be the hottest year we've seen. We saw excessive rain and flooding in Brazil earlier this year, which was worsened by El Nino, and killed over a hundred people and injured several hundred more. There were heatwaves in South and Southeast Asia, namely Philippines, Thailand, Bangladesh, India. They all saw excessive heat and drought. Earlier wildfires in Canada happened this year as well. We saw Storm Boris in Central Europe, which caused massive floods, and then obviously in the U.S., we recently saw Hurricane Helene and Hurricane Milton, both of which knocked out power to over 300 million people, and I've seen estimates for different damages still outstanding, but the ranges have been from 15 billion to 60 billion, so all of these things are really hitting us today, now. Then you can couple that with a lot of these reports, namely the latest IPCC report, which suggests that we'll likely see temperatures rise by at least one and a half degrees Celsius before 2050, and studies that suggest that even if the NDCs are met, it's unlikely that we'll stay below two degrees, but rather that we're on track for about somewhere between 2.8 to 3.2 degrees Celsius of global temperature increase. And actually, the latest UN Emissions Gap Report also came out last week and suggested that we should be preparing for warming well above one and a half degrees in the medium term and likely above two degrees by mid-century. So these physical effects, we're really feeling them today, and predictions for the future are not looking especially optimistic, so there is a greater sense of urgency that we're perhaps not sufficiently on track to mitigate some of these extreme climate events. And then you layer on some of the recent COPs, which have really been focused on mobilizing capital for adaptation, mitigation, resilience, and this has, I think, really brought in the investor community, because inevitably private markets have been now looked towards as a source of financing. So there is an increased understanding that investors really can and now want to be a part of the solution and that they may actually, along the way, find attractive opportunities, looking into how we can finance climate transition. So all of this, I think, coupled together is fueling some of the demand that we're seeing from our clients. I mean, I'll ask you, Ed, if you agree that the topic of climate has really been increasing among conversations we've had with existing and future clients?

Edward: Yeah, so actually, it's a hot topic at the moment, and indeed, it's probably been an interesting topic for the last three, four years, but the evolution on the way people are looking at climate has changed relatively significantly and I think that has been picking up pace, but if I started with what have we been doing in portfolios for the last sort of three, four years, where climates come in there, it's been much more looking at WACI. So on our next chart, you can see a distribution of the WACI of various different companies within an investment-grade universe, but what you'll see when you look at WACI is that there are a lot of carbon-intensive industries which make up pretty much all of the carbon emissions, and then there is an enormous long tail of companies that really don't contribute very much towards carbon. So financial industries, etc., they don't really have any carbon emissions, and therefore, when you're looking at the WACI of a portfolio, they don't contribute much and you get sort of distorted answers into how to reduce your WACI. So simplistically, the past approach to carbon emissions has been "please reduce the emissions within a portfolio," and as you can see from that very sharp increase of the small amounts of hugely carbon-intensive issuers, the simplest way to achieve that has been more sector rotation than looking for people who are on a journey to reduce their carbon emissions. So in an investment-grade portfolio, the industries that are hugely carbon-intensive would be utilities, chemicals, and energy, and if you wanted to reduce your carbon emissions in your portfolio, simply you roll out of those three sectors and go towards banks, if you want one example. That tends to be an issue of you're looking at what the companies have done in the past rather than what they're going to do in the future, what are they committed to with carbon transition, etc. So that has been the starting point of the conversation, and I'll wait a little bit and hand back to you, Armelle, before I go into what can you do going forward and how has that conversation evolved.

Armelle: I think it would help us just set the stage. I think historically, there was a real heavy focus on what we're going to call "green funds." People wanted to make sure that they're allocating money in a way that's good for the world, and the easiest way to do that stemmed first out of also the traditional SRI approach, which was divest from things that are bad and only invest in things that are good, and the easiest way to show that is through simple metrics, so whether that was only investing in green bonds or looking at a weighted average carbon intensity metric, these were very simple metrics to show on paper that a portfolio is having low impact, and I think we're starting to see a shift in narrative towards transition because people are realizing that the traditional way of doing things, looking at metrics like WACI, just resulted in things like sector rotation, like you just mentioned, Ed, and a lack of real-world impact. Fact of the matter is, emissions are still rising. In 2023, we saw an increase in emissions of 1.3%, so the traditional way of doing things hasn't actually led to real-world decarbonization. We need a lot of these industries. We're going to need metals and mining companies. We're going to need chemical companies and need the energy sector, even if it does look a little bit different, but there started to become a realization that just divesting from brown companies doesn't make them greener. In fact, it's raised the cost of capital for them and has made them less likely to invest in green technologies and become greener, so instead, they've become browner, and that's, I think, the shift that the ESG industry needs to really reckon with, is that we can't just close the door on some industries. We really need, if we want to have real-world impact, we need to figure out a way how they can transition and be a part of the solution. That's, I think, where engagement also plays in. We've had these conversations as well, Ed, but engagement certainly has a role to play here in the transition as well. So I think we're seeing ESG investors recognizing this, but in order to finance the transition, we do have to be a bit creative. So maybe I'll turn it back to you, Ed, on maybe some ideas on how we can actually implement something that's impactful but also generates returns.

Edward: Yeah, and so when you go to an investment-grade universe, I mean, really broad-brush numbers, but you've got 30% of an investment-grade universe that are in sectors where they might be more predisposed to carbon emissions. So if you divide the world into sectors with low carbon emissions, actually looking at their climate alignment isn't always the most helpful thing from a portfolio construction point of view. And the reason why I say that for low carbon emitters is, if you spend your time engaging and trying to get software companies to decarbonize when they don't really put any carbon emissions there, it doesn't really make much difference to the real-world environmental impact. So in a portfolio, when you're building and looking at the climate, it's much more important to look at the 30% of industries that are likely to have higher Scope 2 or Scope 3 emissions, and then in order to look at the impacts and get the real-world impacts on the environment, you need to look at those companies and what journey they are on rather than just that they're WACI. So to give an example of that, if you've got a company that makes aluminium and they want to decarbonize, they want to have an electric smelter rather than a coal-fired solution, then those companies, if you purely look at WACI, you will never invest in because their WACI is going to be off the charts, but those companies equally may have hugely ambitious targets to be Paris-aligned, etc., on a decarbonization route, and if their plan is to shut off their coal-fired smelter and build a brand-new one, then that's going to have huge real-world ramifications or positive ramifications for decarbonizing. So when you look at the, I guess, the more forward-looking rather than backward-looking solution in how you can encompass that into portfolios, it is much more about analyzing the companies that have high carbon emissions and separating out those that have no ambition to change, improve, etc., from those who clearly do but need capital support on the journey in order to decarbonize. So we've done lots of work to try and break those down. I say "we" in the loosest sense. The ESG team have done lots and lots of work to differentiate between the companies that are high carbon emitters but actually good versus high carbon emitters and no plans, which gives you a real universe of opportunities that will make a positive difference to the environment rather than the danger of just sector diversification -- or not sector diversification, sector reallocation in order to reduce WACI.

Armelle: Yeah, I love that you distinguish that, Ed, because I think it is important, those issuers that are high emissions-intensive, if they were to reduce their emissions by even 1%, that impact in absolute terms is so much greater than, like you said, a software company that's reducing its emissions even by 20%. So that's definitely something that we've really focused on through some of our internal tools, like our temperature alignment tool, but there's another aspect also that we consider especially with climate, because when we think about temperature alignment, we're really thinking about organic decarbonization of an issuer's operations. The other element of that, obviously, though, is products and services, so what are companies who are deriving their revenues from a product or a service that is mitigating climate change or offering adaptation solutions. So I think coming back to the idea of being creative here, we really need to think about an issuer's holistic impact and what are all the different ways that they can be having a positive impact and not trying to just focus in on one individual metric that just looks good on paper, but rather, really think about the outcomes, so these are really the type of issuers that we would love to target. Obviously, there aren't a plethora of these types of issuers across the investment-grade universe, so we do need to also look at what are issuers that remain what we call "climate-neutral." And as you can see on this chart, that 64% of the benchmark represents about 8% of the benchmark's carbon intensity, which I think Ed alluded to also in the previous chart, but these are what we call "climate-neutral" names, and we retain to also aid in portfolio diversification. Ed, I don't know if you want to touch on that some more.

Edward: So that's the easy bit, and it's probably worth highlighting that it's not all easy from a portfolio management perspective, so if you look at the companies that we would regard as have very little intention to improve for the climate in the negative impacts, they probably have on average a slightly wider spread, and the companies that are climate-critical and are doing the right thing often have a slightly tighter spread, so when you do this, you make a real difference for the environment, but there are a few complexities in terms of making sure that you can maintain a nicely risk-balanced diversification of industries and names within your portfolio and also making sure that you have the opportunities in order to generate alpha. So there are a few more things to solve for, but you can clearly see that if you go and embark on this approach, rather than looking at the total carbon emission in your portfolio, you're almost more saying that the carbon emissions within the portfolio are actually doing the right thing, and therefore, the number in of itself isn't quite so important, which is a huge change from just looking at your WACI, where it's not about whether these are improving carbon emissions, it's all about just having lower carbon emissions. But let me ask you, in turn, because I've highlighted the fact that actually there are some challenges for me in generating a portfolio with enough yield, etc., etc., but it's not just when you're looking at portfolios going forward that are trying to address this issue. It's not just me and our view on temperature alignment that poses questions. There are a lot more regulations coming in, and are those likely to have impacts on the way you can construct a portfolio?

Armelle: Yeah, absolutely, and I know we've had a lot of conversations about regulations because it feels like every six months there's something new that we come to Ed's team about and give him a heads-up. So I think one of the big ones that we're faced with recently is the ESMA names rule, so under the ESMA names rule, if you have a fund that has a certain term in its name like "ESG," then you have to apply the Paris-aligned benchmark exclusions, and if you have terms like "transition" in the name, then you have to apply the climate transition benchmark exclusions, so this is definitely something that we have to consider when naming funds because, also, previously, a lot of funds were titled "ESG." There weren't a number of different types of ESG funds in terms of how they were named, so a lot of them were named "ESG," but their objective may have been more aligned with things like transition. The term "transition" didn't really become mainstream, I would say, until more recently. So now if you still have "ESG" in the name, you have to follow the PAB exclusions, which, among other things, means excluding companies that derive 10% or more of their revenues from exploration, extraction, distribution, or refining of oil fuels, as well as companies that drive 50% or more of their revenues from exploration, extraction, manufacturing, or distribution of gaseous fuels. So this inevitably does have a very significant impact on the energy sector, but I'll also remind that with the PAB benchmark, as a reference benchmark if you choose to use so, there's also a target of reducing emissions by 7% a year. Now, I say that because that's a pretty ambitious target when the real world isn't decarbonizing. So I mentioned emissions are actually rising globally and it's unlikely that we will see, even if emissions do start declining, that we'll see a lovely linear path of 7%. Emissions reductions will likely happen in bits and spurts. But what we're seeing is that a lot of funds that are using the Paris-aligned benchmark, the way that they're compensating for this and compensating for the fact that the real world isn't decarbonizing, is usually by having higher and higher tracking errors. Eventually, that's going to cause some problems when the underlying constituents aren't decarbonizing, but also just in general, the restrictions on the energy sector do play a role and certainly make Ed's job not easier when 90% to 100% of the energy names get excluded. So Ed, maybe turning back to you, how does this impact you and where do you find value for replacements?

Edward: Well, it makes it even harder, right? And typically, if you look at a lot of the energy companies, a lot of them will be excluded because they don't actually have carbon or decarbonization goals, but there certainly are a few that do and that present the opportunity to give some balance to the portfolio, including energy, but when you just have a hard ban on a sector, if it is a material part of the benchmark, you do get distortions, and it's not always easy to replicate the risk. Ultimately, you begin to replicate it on a portfolio level rather than the energy industry has its own dynamics, its own idiosyncrasies, which you can't really replace with any other sector, so you have to accept that there will be noise, and often, I mean, just from my perspective, I mean, because it is what it is from those, but you would rather accept the fact that, yes, energy has its problems, but there are some companies that are trying to do the right thing, and you would rather have the ability to encourage that behavior rather than effectively just drawing a line through the whole sector and giving up. It makes my life from a portfolio management perspective harder, but it also, I would have thought, makes the conversation a little bit harder if you're basically saying, "I don't want to talk to you because computer says no." But yes, so slightly problematic from that point of view.

Armelle: Yeah, I think the irony in all this, as previously mentioned, we're not going to keep temperatures from warming or keep temperature warming to under two degrees in alignment with Paris unless we transition, but I would argue that some of the restrictions from the Paris-aligned benchmark exclusions will actually hinder us from transitioning because we'll just be excluding the whole energy sector instead of, like you said, incentivizing those issuers that are doing the right thing and continuing to finance them. So I think from our perspective, obviously, from your perspective, they're not tools that make your life easier, but from our perspective also, the Paris-aligned benchmark exclusions can be counterproductive or maybe ineffective to actually achieving the Paris goal. So I think we're nearing the end of our time together, but maybe I'll just touch on a couple of key takeaways from the discussion. So I think, firstly, the industry is beginning to recognize that pure divestment is not leading to effective change, and it has been thinking more about the transition and how it makes more sense, both from an impact and an investment perspective. And the second thing is historical climate metrics are not sufficient to truly consider an issuer's holistic impact on climate mitigation, and thus can't fully support transition investing, and we need to be turning towards other metrics and especially more forward-looking metrics. And the last thing I think I'll say is I'll implore anyone that's thinking about investing in the transition to avoid thinking in narrow terms of simply one ESG metric. Piece together a mosaic of information to give a more accurate reflection of an issuer's impact. No issuer is going to be perfect, but issuers can be having a positive impact and contributing to the transition in very different ways, so make sure that you don't inadvertently ignore these facets. This is at least what we've been trying to do when thinking about investing in the transition. So with that, thank you, Ed, for the insightful discussion, and thank you to our audience for joining us today and for your continued confidence in PGIM Fixed Income.

IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of October 2024.

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