

# Climate Investment Principles

## Executive Summary

AUGUST 2022

### WHY CREATE CLIMATE INVESTMENT PRINCIPLES?

For Pictet, climate change represents both an urgent challenge and an opportunity to build a more sustainable economy. We believe climate change will have a material impact on asset prices and investment returns in the coming years. We also believe that, as stewards of global capital, the investment decisions we and our peers take today will have a strong bearing on how climate change and its consequences ultimately unfold.

#### A. ECONOMIC IMPACT

Climate change represents an externality which will increasingly be internalised through a mix of taxation, regulation, innovation and behavioural changes – now and for at least the next 50 years.

- I. To determine the true cost of shifting to a sustainable economy, investors must acquire a deep understanding of both the physical risks of climate change and the transition risks associated with decarbonisation.
- II. Reducing the impact of climate change involves a significant step up in investments – both public and private – that will pay off well into the future.
- III. Policy changes will play an important role in shaping markets and companies in the transition.

#### B. RELATIVE COSTS

While efforts to mitigate the effects of climate change come with a high up-front cost, those costs pale in comparison to those of taking no action at all.

The complexity and uncertainty surrounding the economic impact of climate change require investors to integrate scenario planning into their decision making and to regularly reassess their climate assumptions, to avoid a static understanding of a dynamic topic.

#### C. STRATEGIC ASSET ALLOCATION

The impact of climate change is a discrete risk that should be embedded in the evaluation of all investible assets. There is a market-wide risk premium and asset classes, sectors and companies carry varying sensitivities to this factor.

- I. The transition to a point where assets embed a “steady state” risk premium is a dynamic process which will unfold over many years. Understanding where investments sit on this continuum is a first step towards identifying investment opportunities for excess returns.

Over shorter time horizons, green assets may be overvalued just as brown assets may be undervalued.

- II. Today, physical risks are especially under-appreciated and under-priced in companies. Physical and transition risks can be crystallised and brought forward in the form of liability risks.
- III. No economic system will be immune to the impacts of severe climate change, therefore such a risk cannot be easily diversified or hedged.

#### D. SOVEREIGN BONDS

**The extent to which sovereign bonds are affected by climate change varies significantly from country to country and region to region. Emerging market economies are more vulnerable to climate change than developed world counterparts.**

- I. Any assessment of sovereign borrowers' creditworthiness should take into account the country's exposure to the physical effects of climate change as well as its capacity to adapt to them.
- II. Given the improved look-through for investors and the ability for sovereigns to issue bonds to support specific sustainability goals, use-of-proceeds (ESG bonds) structures represent a win-win development especially when it comes to emerging markets.
- III. In the short-term, developed economies appear more vulnerable to transition than physical risks. These risks can be determined by examining each economy's long-term and interim climate targets, the scope of such plans, and the extent to which policies are enshrined in law.
- IV. It is more difficult to have reliable commitments from sovereigns than from corporates as the transition requires hard political decisions on the sharing of costs.

#### E. CORPORATIONS

**Companies' decarbonisation efforts and the quality of their climate-related governance and carbon disclosures will play an increasingly important role in determining the cost of equity and debt capital through dispersion of risk and expected return. All of which means that bond and equity investors will need to pay much greater attention to non-financial factors when assessing a firm's investment potential.**

- I. The impact of climate change on the valuations of equities and corporate debt varies by industry.
- II. Companies are vulnerable to physical and transition risks in various ways, expressed through risk premiums, revenue growth, free cash flow and margins.
- III. To identify companies capable of making the fastest progress towards decarbonisation, investors require a deep understanding of corporate governance, strategy and investment plans.

#### F. PRIVATE MARKETS

**Private asset classes are more exposed to the impact of climate change because they are far less liquid and of longer duration than most other investments.**

- I. There is greater need to correctly price climate risks and opportunities on longer duration investments such as private assets.
- II. Private assets are not subject to the same degree of environmental scrutiny as their publicly-traded counterparts. The degree of scrutiny varies considerably from one type of private investment to the other. But climate-related regulations are sure to tighten right across the private market, triggering a fundamental re-pricing of assets although the magnitude and timing may depend on the asset class.
- III. In private markets, the ability and responsibility of the investor to affect change is elevated given the direct role as a financier, and level of control.

## G. CAPITAL ALLOCATION

**The investment community affects climate change outcomes through capital allocation decisions.**

- I. In order to incentivise GHG emissions reductions we need to allocate capital to companies and countries that are in the process of reducing their emissions, and couple this with effective engagement, creating a ripple effect beyond our investments.
- II. Capital allocation is also needed to support the growth of companies and opportunities (including in hard-to-abate areas) which can exist within or contribute towards a low-carbon economy.
- III. Exclusion is also a capital allocation decision but should only play an important role if there is an absence of capability or executive will to transition.
- IV. Transparency and disclosure provide us with the information we need to rebalance our portfolios, and make our allocation decisions visible to clients, regulators and investors.

- IV. By being vocal on climate-related issues and working with like-minded peers to shape the public debate, Pictet can help accelerate the transition. This ultimately helps to maximise both impact and opportunities.
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## H. ACTIVE OWNERSHIP

**Active ownership activities can contribute positively to climate change outcomes and protect and/or enhance shareholder value creation.**

- I. By supporting and accelerating transition plans through engagement and voting activities we aim to contribute to the goal of keeping global warming limited to 1.5°C above pre-industrial levels and reach net zero carbon emissions around 2050.
- II. Engagement is most effective when an investor leverages a particular area of expertise and/or when it is done as part of a collective effort. We believe engagement efforts should possess the following characteristics: they should focus on issues that have a material effect on our portfolios and on matters on which we can claim genuine expertise and influence.
- III. The ability of an investor to influence change in a corporate is typically larger than in a sovereign context, and particularly in EM - with some exceptions.