COP26 Climate Conference in Glasgow – Key Takeaways and Potential Investment Implications

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As experienced investors know, key geopolitical and macroeconomic events are important to understand in calibrating the investment risk strategy for their investment portfolios. The recent 26TH Conference of the Parties (COP26) led to material agreements between the participating nations across various different work streams for the ultimate goal of working together to reduce global warming to 1.5C degrees through the reduction in greenhouse gas emissions. The following article seeks to distill the key takeaways of COP26 and to contemplate the potential investment implications of the developments and agreements reached by COP26 participating government officials, corporate executives, and financial leaders during the event.

Key Takeaways

- The narrative has turned to transition pathways and providing companies with reasonable latitude to craft their carbon transition plans. During the next 12-18 months, public companies will be formulating their carbon transition plans with public disclosure likely to follow shortly afterward. The first objective for companies will be carbon mitigation after which companies will provide disclosure of their plans for offsetting emissions as a path toward reducing their carbon footprint toward their net zero aspirations. Companies will consider their supply chain in this evaluation as well as their ecosystem of stakeholders (such as employees, customers, shareholders). However, emphasis was placed on the idea that this is not a flip-the-switch initiative and important for companies to be thoughtful in their analysis and planning in order to mitigate systematic risk.

- Banks are including climate risk criteria in their credit policies for loan underwriting and will partner with companies to ensure a smooth transition. It's still too early to determine the exact nature of these updated underwriting standards as they will be partially based on regulatory changes still being formulated. Banks will also be involved in providing capital market solutions, such as foreign exchange hedging facilities and working in partnership to create a functional carbon market.

- The International Financial Reporting Standards Foundation (IFRS) announced the formation of the International Sustainability Standards Board (ISSB), an investor-led sustainability board tasked with leading the development of standardized sustainability disclosure requirements to meet investors' information needs. This was developed in response to the call by international investors for high quality, transparent, reliable and comparable reporting by companies on climate and other environmental, social, and governance (ESG) metrics.

- Consolidation of the Climate Disclosure Standards Board (CDSB) and the Value Reporting Foundation (VRF) by June 2022. This is a further consolidation and alignment of standards to help the consistency in the industry.

- Progress on Article 6, which relates to the formation and functioning of a carbon market to facilitate carbon price discovery and the trading of carbon credits. The idea is that a discoverable price for carbon, particularly one above $100, will help to incentivize industry participants into lowering their emissions. California currently has an active "cap-and-trade" system in which the trading of carbon credits themselves occurs between companies but are authorized and regulated by the state. Each company is provided a maximum carbon pollution allowance, which is denominated in metric tons. This topic will be the subject of another article, once further details are released.

- Publication of prototype climate and general disclosure requirements by Technical Readiness Working Group representatives from the following groups: CDSB, International Accounting Standards Board (IASB), Task Force for Climate-Related Financial Disclosures (TCFD), World Economic Forum (WEF), and the International Organization of Securities Commissions (IOSCO).

- Discussion around the valuation of nature-based resources. The main takeaway is that natural resources are a scarce asset and should be valued accordingly. There was significant discussion about protecting the rights of indigenous populations who inhabit natural resources.

- Agreement by nearly 200 countries on a climate deal and net zero timelines despite surprising last minute changes insisted by both India and China to weaken the language on coal and fossil fuels. A compromise was reached on a pledge to phase "down" rather than phase "out" coal, leaving many vulnerable countries and small island states very unhappy with the change. More than 100 countries, including the U.S. made a "Methane Pledge" to cut emissions of methane, a potent warming gas.

Where Might This Lead? Implications for Investment Portfolios

- There was significant discussion at COP26 regarding the need for capital to flow to developing and emerging market countries which continue to suffer significantly from the effects of climate change and lack the resources to handle the challenges.

  - Increased investment in emerging market countries which will strengthen their currency as capital flows in and to the extent their currencies are pegged to the U.S. dollar, strengthen the U.S. dollar. Many in the institutional investment community regard emerging markets investments as a leveraged play on the U.S. dollar.

- Positive revaluation of assets previously considered illiquid and written down, such as certain natural assets. This could represent a new valuation mosaic which considers certain commodities a scarce resource which must be allocated in a careful manner.

- Significant marketing initiatives across investment advisors regarding the importance of ESG investing and widely available ESG data sets. Investors may not realize that there is significant inconsistency in the data as the current governing approaches for quantifying a company's carbon footprint is subject to interpretation regarding the appropriate standards to apply. Until the previously mentioned convergence of carbon measurement standards and quantification approaches occur, it will be important for institutional investors to scale their knowledge quickly in order to fulfill their fiduciary duty to their organizations. As experienced investors know, metrification without experienced calibration can lead to false assumptions and investment mistakes that can otherwise be avoided.

- Carbon taxes or incentives to encourage desired economic behavior as it relates to carbon mitigation. This is shifting of the deck chairs. The issue that could result is a revaluation of commercial or residential real estate, which would have serious consequences that could resonate through the local, regional, and national economies if not handled with care and in a fair and transitional manner.

- Noise regarding greenwashing through transactions from public entities which will be pushed to disclose their carbon emissions from a regulatory perspective to private entities or countries where these disclosures are not mandated.

  - Required knowledge for investors to understand the implications of carbon valuation on portfolios, beyond the obvious candidates impacted by climate change, such as real asset investments in private energy and real estate.

Contact Us

We continue to monitor the potential investment risk implications of the quickly evolving climate risk and carbon measurement disclosures required by global regulatory entities. This article is the first of a series to be published in the upcoming months.

If you have any questions about this article, please contact your engagement partner or:

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