How We Should Be Thinking About Carbon Risks in Portfolios

By Foresight Analytics | December 2020 | Blog Post

Source: ABC News (2019)

Global warming is here to stay, and nations are desperately trying to prevent its continuation to avoid our earth from becoming inhabitable. It may already be too late, but international agreements such as the Paris Agreement (2015) demonstrated a global effort to mitigate Greenhouse Gas Emissions (GHGs), with the participation of 194 countries. While the implementation of this legally binding agreement has been quite poor, ESG investors are aware that the transition to a carbon-neutral economy is already underway and can be hastened through their responsible investment decisions. This includes reducing the potential carbon risks posed in their funds and portfolios.

Carbon risk entails how many tons of GHGs a portfolio company generates per a million of dollars in revenue. According to the GHG Protocol Corporate Standard, carbon risk measurement involves direct emissions (e.g. manufacturing process, company vehicles), indirect emissions – owned (e.g. purchased electricity, steam, heating and cooling for own use) and indirect emissions – not owned (upstream and downstream activity, e.g. employee commute and franchises). Carbon risk thus allows us to draw conclusions on carbon-related market and regulatory risks for portfolio companies differing in size and operation. It also ensures investors can identify green or brown portfolio companies, helping them develop a mitigative stance.

Measuring and publishing carbon risk of companies will encourage reducing carbon emissions, though it is also important to realise how studying carbon risks in isolation can also be misleading. The Qantas Future Planet Program for example, invests in carbon-offset projects, and ESG investors identify these carbon-offset activities as valuable mitigation strategies for the air travel industry due to the knowledge that the industry itself will take a long time to become carbon-neutral. Nevertheless, the carbon risks in isolation may also fail to tell us the entire story. Coal-mining companies demonstrate a surprisingly low carbon footprint despite the emission-reliant industry, given that their emissions from coal-based energy is downstream, run outside of company operations and are excluded from a company's carbon footprint. This highlights how carbon risk numbers are not wholly encompassing of how a portfolio company is utilising Co2 emissions, standing as a reminder of the importance of due diligence in assessing the 360-degree perspective of a fund.

Foresight's efforts to combine data-driven and human-insight based solutions for investors reflects our capacity to capture a 360-degree understanding of ESG risk, particularly through our risk and quality-based assessments. Our assessment frameworks employ a thorough analyses of ESG risks through quantitative, forensic mechanisms as well as through qualitative ones. This enables us to understand portfolio companies beyond numbers, looking also at people, processes and operations that substantially impacts their carbon footprint.

About Foresight Analytics

Foresight is a data-driven investment research, analytics and consulting firm. As an independent employee owned firm, Foresight does not have any affiliation with product manufacturers or distributors. Using its innovative evidence-based framework, Foresight provides analytical, predictive and market intelligence solutions to leading investment management companies, superannuation funds and wealth groups. Foresight's capabilities are underpinned by leading data and technology infrastructure that blends statistical, fundamental and behavioural insights.

Foresight's fiduciary solutions include quality and risk-based investment research, global economic and market analyses, forensic validation of manager skill in active funds, portfolio risk aggregation and factor-based portfolio construction. Foresight's fund strategy solutions include competitive advantage analysis, fund industry intelligence and competitive benchmarking, behavioural alpha analysis, sustainability analytics and integration as well as strategic investment process review and development.

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