Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Advance Warming

INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | SEPTEMBER 2021

The summer months in the Northern Hemisphere brought wildfires in the Pacific Northwest large enough to redden skies in New York, devastating floods in Germany, heat waves in Siberia, unprecedented fires in Turkey, Greece and Italy, and once-in-a-millennium rains in China. Scientists are evaluating the extent to which these events have a compounding effect, with global warming driving increased aridity and fires travelling upslope in areas previously too wet to burn, only to be followed by torrential downpours and devastation on faraway continents as warmer air carries more water. If the jet stream (the high-altitude winds circling the Northern Hemisphere) is being disrupted, the usefulness of past weather patterns for predicting future patterns and the probability of extreme climate events are called into question. The summer of fire and floods has also raised questions about whether disaster recovery plans are correctly aimed at tributaries as well as main rivers, the role of dams in subverting the natural course of rivers, whether heat waves should be named and rated like hurricanes, and how meteorologists should communicate warnings to the general public.

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"Even a moderate emissions scenario will see temperatures rise by 2.1 to 3.5 degrees Celsius over the next 20 years"

After July 2021 produced the hottest global monthly average temperature on record, the heat is still on ahead of the COP26, the United Nations climate summit in Glasgow. The August release of the Intergovernmental Panel on Climate Change report, compiled by more than 200 scientists, suggests that even a moderate emissions scenario with little change in today's global development patterns will see temperatures rise by 2.1 to 3.5 degrees Celsius over the next 20 years. Achieving global warming targets lower than that—to avoid irreversible glacier retreat, Arctic ice cover loss or ocean warming—requires "immediate, rapid and large scale" reductions in greenhouse gases, with a growing focus on methane from natural gas fields and cattle and its significantly higher warming potential than carbon dioxide.

The European Union's Fit for 55 policy proposals are more likely to be taken seriously against a backdrop where the dangers of climate risk seem more pressing. The European Commission is beginning to plot a road map towards more carbon taxes and new carbon border adjustments for polluting industries (i.e., carbon tariffs), phasing out petrol and diesel car sales by 2035 across the bloc, while encouraging renewable industries and protecting carbon sinks like forests and other ecosystems that are crucial to carbon balance in the atmosphere. The winds of change focused on inequality have also seen the proposal of a Social Climate Fund to support those disproportionately disadvantaged by rising costs. U.S. Democrats are proposing carbon import tariffs in response to this, raising the bar on climate policy, while China has launched its own national emissions trading scheme—now the largest in the world.

So, what do we think about climate change, and how does our team manage our responsibility to adapt to the growing importance of environmental, social and governance (ESG) and sustainability concerns?

> "Pathways to reduced emissions may create opportunities for low-carbon solution providers; regulation could reduce profits"

In our view, climate change presents an array of risks and opportunities for companies, and these are high up on the list of issues which we consider, case by case, including whether and how material they are to the sustainability of any company's returns on capital. Pathways to reduced emissions may create opportunities for low-carbon solution providers, but regulation including taxation and carbon pricing could reduce profits. Extreme weather may impair physical assets or interrupt business activity. Energy transition may result in stranded assets and wasted investment. Further, companies that are not adapting or that are moving more slowly than the competition could risk their reputation and potentially lose customers.

As part of our integrated approach to ESG factors, we seek to directly engage with our companies to evaluate their position on climate change. Each company has a different starting point, a different exposure and is typically at a different stage in its decarbonisation journey. Our climate and carbon company engagements typically address areas including governance, targets, transparency, implementation, progress, physical risk, product and service opportunities and stakeholder alignment.

Our global portfolios, ever bottom-up, and invested in sectors with high intangibles and low tangible assets relative to other sectors, enjoy the benefit of a smaller physical footprint and lower physical risk of extreme events relative to other sectors. Key holdings in software typically have a low carbon footprint per unit of revenue, as well as emerging opportunities to sell much-needed tools to help their clients measure and minimise their environmental impact. The direct footprint of staples and health care factories and distribution fleets remains significantly lower than the index, although that doesn't minimise our focus on their efforts; typically, in these engagements, we focus on areas such as sustainable sourcing, packaging and other indirect (Scope 3) effects.

> "Our global portfolios invested in sectors with low tangible assets enjoy the benefit of lower physical risk of extreme climate events"

In the first six months of 2021, we engaged on ESG issues with our companies on 81 occasions, of which 55 engagements focused on environmental issues. We are systematically and intensively engaging with our companies on their decarbonisation strategies. But an improved environment cannot be achieved through decarbonisation alone. Companies (and fund managers) need to be increasingly conscious of—and help find solutions for—excessive natural resource depletion, waste and water intensity and their impact on biodiversity. As such, our systematic engagements with companies focus on a broad spectrum of ESG topics, particularly those material and germane to the company in question. We have our work cut out for us.

An uncertain environment of climate change, geopolitical posturing, and rising rather than receding incidence of new COVID-19 variants around the world mean that, while we remain alert to potential opportunities, we continue to steer towards caution, focus on sustainable earnings and cash flows, direct capital towards ESG-aware management and emphasise valuation discipline.

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CRC 4958353 Exp. 9/30/2023 Lit-Link: GLBQOBV-0921 10284991_KC_0922
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