ESG Viewpoint

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Climate change in the Responsible Funds range

- Climate change is one of the defining issues of our century, with wide-ranging investment implications.
- In light of this, BMO Global Asset Management reviewed the fossil fuel criteria for our Responsible Funds range in 2015.
- Our conclusion was to adopt an approach combining exclusion of the most harmful activities; positive engagement with companies; and investment in solutions.

Climate change is one of the defining issues of our century. There is an overwhelming scientific consensus that emissions of greenhouse gases – largely from burning fossil fuels – are leading to rises in global temperatures and changes to climatic conditions. Without action, climate change may irreversibly change our planet, with damaging and unpredictable impacts on human life and the environment around us.

Faced with the facts, after more than two decades of international negotiations, the 2015 United Nations Climate Change Conference ('COP21') in Paris saw 195 governments agree that the global temperature rise should be limited to 2 degrees Celsius – which means transitioning to a low carbon global economy by the second half of the century. Investors were a strong voice in the run-up to the Paris negotiations, and BMO Global Asset Management (EMEA) was an active participant in these efforts[1].

Fossil fuels: can they be ethical?

The Paris deal has wide-ranging investment implications, with the commitments made by politicians creating potential financial risks to companies involved in fossil fuels as well as those exposed to physical changes in the climate. A range of tools are fast emerging to help investors understand and mitigate the nature of these risks.

For investment strategies with an ethical mandate, climate change raises additional challenging questions. Is it still moral to invest in fossil fuel energy at all? How do we balance the moral imperative to avoid damaging emissions against the need for people to have affordable access to energy? And what is the role for investors in driving solutions to the problem?

In 2015, BMO Global Asset Management's Governance and Sustainable Investment (GSI) team worked together with its Responsible Investment Advisory Council[2] to review the fossil fuel policies of our Responsible Funds range. Our focus was on the three sectors most directly involved in fossil fuel production and consumption: oil and gas, mining and utilities.

[1] The Paris Climate Negotiations: A world in transition, BMO Global Asset Management, 2015

[2] The Responsible Investment Advisory Council advises BMO Global Asset Management (EMEA) in relation to the Responsible Funds range. It is chaired by Howard Pearce, formerly of the Environment Agency Pension Fund, with the Archbishop of Canterbury, Justin Welby, acting as President.

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All fossil fuels are not the same

Our approach to climate change recognises that the three types of fossil fuel – coal, oil and gas – have different global warming characteristics as well as uses.

Coal: Coal is the most carbon-intensive of the three fossil fuels, with over 210 pounds of CO_2 emitted per Btu (British thermal units) of energy produced[3]. It is also a major contributor to air pollution; one recent report estimated that air pollution is the cause of 1.7 million deaths a year in China, with coal a significant contributor[4].

Oil: Oil has a lower carbon intensity than coal at 157 pounds of CO_2 per Btu. The main use of oil is in transport; unlike gas and coal, which can be substituted by renewable energy, oil has few direct substitutes and continues to be needed to provide mobility, although the electrification of the vehicle fleet will change this over time.

Gas: Natural gas has a substantially lower carbon intensity at 117 pounds of CO_2 per Btu. As a substitute for coal, gas has an important role as a transition fuel in the medium term, although its use will also need to be limited over time in order to meet the goals set at the Paris UN Climate Change Conference.

Reviewing the evidence

We considered the latest science, policy and public opinion, drawing on both our in-house expertise and input from external experts, including the Non-Governmental Organisations (NGO) Carbon Tracker, which has been at the forefront of the debate over investor action on climate change.

Key factors considered were:

- The evidence of the link between fossil fuels and climate change is indisputable, and the threat of unabated climate change is huge. Unabated climate change could lead to a global average temperature rise of 4 degrees Celsius or more, with risks including increased water stress, mass biodiversity loss, increased incidence of floods and storms, and the spread of tropical disease[5].
- Access to affordable energy is essential for human and economic development, and is one of the United Nation's 17 Sustainable Development Goals. With one in five people still lacking access to modern electricity, and three billion relying on wood, coal, charcoal or animal waste for cooking and heating – with all the associated health, air quality and safety risks – enormous progress needs to be made before this goal can be achieved.
- Fossil fuel-based energy is still an important component of the global energy mix, and will remain so for a considerable period of time even under the most ambitious scenarios for a transition to a more sustainable energy system.
- Whilst the energy transition is achievable at a comparable net cost to 'business as usual'[6], it will require substantial upfront investment, with additional needs for clean electricity infrastructure capital expenditure recently estimated at over $12 trillion[7].

A balanced approach to exclusion

Balancing these factors, we take the view that exclusion of all fossil fuel-based energy in the Responsible Funds would be premature. We also take the view that by continuing to take a stake, we can exert a positive influence through engagement, as set out below.

However we also believe that companies making a large contribution to greenhouse gas emissions, and who lack a credible pathway to change, are incompatible with the underlying philosophy of these funds, which is to avoid companies that we believe are causing harm.

We therefore take a systematic and selective approach to exclusion, based on three key factors: the fossil fuel itself (coal, oil or gas – see sidebar); the energy intensity of the production technique used; and companies' policies and strategy towards climate change.

We have set the following criteria in relation to fossil fuels and climate change[8]:

- **Exclude mining companies with over 10% of revenues from thermal coal production.** We wish to

[3] US Energy Information Administration

[4] 'Air pollution in China: Mapping of concentrations and sources', Berkeley Earth (2015)

[5] Intergovernmental Panel on Climate Change, Fifth Assessment Report (2014)

[6] World Energy Outlook: Special Report on Energy and Climate Change, International Energy Agency (2015)

[7] 'Mapping the gap: the road from Paris', Ceres and Bloomberg New Energy Finance (2016)

[8] These policies apply to our Responsible Global Equity, Responsible Sharia Global Equity, Responsible UK Equity Growth, Responsible UK Income and Responsible Sterling Corporate Bond strategies. Our Responsible Emerging Markets Equity ESG strategies have a different set of criteria. For this strategy, in relation to fossil fuels we will exclude all companies with over 10% of revenues from coal production, as well as assessing their approach to addressing climate change risks, including policies for reducing emissions, lobbying approach, and strategies for positioning the company for a low carbon economy.

avoid companies with a substantial proportion of revenues from coal mining given the high contribution of coal use to climate change and air pollution.

- **Exclude companies in the oil and gas sector with high-impact production techniques.** We do not at this time exclude companies purely on the basis of their involvement in producing oil or gas. We will, however, take account of the fact that some oil and gas extraction techniques are highly greenhouse gas-intensive, and will exclude companies with particularly high-impact practices. We will not invest in companies with operations in oil sands[9], or those operating in high-sensitivity regions such as the Arctic. We will only invest in companies involved in hydraulic fracturing ('fracking') if they meet an exacting set of environmental criteria, particularly around chemical use and groundwater protection.
- **Assess the climate change policies of all companies in the oil and gas, mining and utility sectors and exclude any that we judge inadequate.** Energy companies can be part of the solution to climate change, if their approach is progressive enough; our review process assesses the quality of company climate strategies. For example, when we analyse companies in the utility sector we look at the efficiency of power plants; the use of low-carbon generation technologies, particularly renewables; the provision of services to help their customers improve their own energy efficiency; and transparency about their approach.

These criteria are assessed by the GSI team alongside other key issues for companies in these sectors, including human rights, health and safety policies and performance, and management of biodiversity and natural resources.

Driving change through engagement

For investors to be part of the solution to climate change, we need to think beyond exclusions, at how we can be a positive voice for change. Where we are invested in companies – either through the Responsible Funds range, or more widely across our full range of funds – we believe that it is part of our responsibility as investors to engage with companies, entering into dialogue with companies in order to identify environmental, social and governance risks, and encouraging a move towards more sustainable business practices.

In the case of climate change, engagement has sometimes been criticised as a 'soft' alternative to divestment. However we see engagement as having very firmly defined hard objectives. We have had an engagement programme on climate change for more than a decade, and over the past two years have engaged almost 100 companies in the oil and gas, mining and utility sectors, seeking four key objectives[10]:

- **Risk management**: To encourage companies to stress-test and disclose the range of possible future energy scenarios used for their strategy planning.
- **Transparency and commitment**: To provide greater disclosure on carbon risks embedded in their assets and to set clearer targets for mitigating these risks by reducing exposure to high-cost, high-carbon projects.
- **Board oversight**: To strengthen board expertise on climate change economics and improve oversight to ensure that business models are resilient to rapid energy transition pathways.
- **Political advocacy**: To ensure that lobbying activities are consistent with the company's stated climate change policies.

We have joined with other investors where possible in order to provide a consistent message to companies about the importance of this issue, including initiatives by the Institutional Investors Group on Climate Change, Ceres, and Aiming For A. We are starting to see leading companies become more willing to discuss the long-term strategic implications in their businesses of the energy transition, and being more constructive voices in the debate.

Investing in solutions

Where possible, we also seek to support sustainable solutions by investing in companies that are helping to make the transition to a low carbon economy a reality. As the alternative energy market continues to grow, there are expanding opportunities to invest in companies in this sector that make both financial and environmental sense.

Within our Responsible range of funds the Responsible Global Equity fund seeks companies meeting a number of positive sustainability themes, including renewable energy; current investments[11] include wind turbine manufacturer Nordex. In the Responsible Emerging Markets ESG strategy, one of the six investment themes is Energy for Growth; investments focus on more resource efficient companies, such as Ultrapar with its Liquid Petroleum Gas distribution network[12]. Within our Responsible Sterling Bond fund, we are invested in a number of green bonds, where revenues are ring-fenced for use in 'green' projects including renewable energy and energy efficiency[13].

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[9] Companies with over 1% in revenues from oil sands are excluded
[10] Stranded Assets – Mitigating investment risk posed by climate change, BMO Global Asset Management, 2015
[11] As at 29 February 2016
[12] As at 29 February 2016
[13] Green Bonds: Financing the transition to a new economy, BMO Global Asset Management, 2015

The road ahead

We sit at a transition point in the climate change debate. The Paris meetings have set a very clear long-term direction of travel, as investors had been asking for; but now the work on implementation begins, both for governments and for asset owners and managers. On behalf of our investors in our Responsible Funds range, BMO Global Asset Management (EMEA) seeks to be part of the solution to the transition ahead. We would welcome your feedback on our approach.