

## Sustainable Funds and Climate Control Wrapped into a COVID-19 World

### Introduction

For decades, climate activists have been clamoring to reduce carbon emissions to reverse course on climate change. Find a way to travel less in your daily life and factories need cleaner energy to save Mother Earth! While COVID-19 is very harmful to our health and the resulting shutdown is detrimental to the economy, it has been a boon to the rest of the planet, including family pets! With two-thirds of the world population in lockdown, the International Energy Agency expected carbon emissions to decline by 8% in 2020, or 2.6 billion tons, to 2010 levels. This is good news for the planet, since the United Nations Environment Program coincidentally said global emissions need to fall by nearly 8% a year until 2030 to meet the 2015 Paris Accord goals. Mission accomplished for 2020, but unlikely to repeat in future years as global economies gradually re-opened.

### Sustainable Funds and Industry Growth

Climate control is a key environment component of Environmental Social Governance (ESG) or Socially Responsible Investing (SRI), collectively referred herein as “sustainable.” Social criteria focuses on work diversity, relationships with employees, suppliers, and customers, whereas governance examples include firm leadership, executive pay, internal controls, and shareholder rights. Morningstar, a third-party data vendor, is among several firms that created standards to measure the various sustainable factors of publicly traded companies. The higher a company scores on the sustainable factors, the more likely it is included into a sustainable fund.

### Sustainable U.S. Equity Funds

Taking a closer look at market benchmarks tracking sustainable funds, performance varied during the pandemic. The S&P 500 sustainable version outperformed the S&P 500, whereas the broader-based Russell 1000 sustainable version underperformed its counterpart benchmark. Beating the benchmarks may not have as much to do with effective asset management than the pandemic impairing “non-essential businesses.” Technology (stay-at-home) stocks performed better than non-essential businesses that are not categorized as sustainable businesses such as the energy, gaming, and airline sectors. U.S. equity sustainable funds generally maintained an overweight to the technology sector but were commonly underweight major tech companies relative to comparable market benchmarks.

Several technology companies score higher on environmental and some social factors due to their low carbon emissions and quality labor relations. For example, Twitter and Facebook announced employees can permanently work from home if they choose. However, many large tech companies score lower on other sustainable factors such as data privacy concerns and tax governance. Starbucks is one of the most popular stocks in sustainable funds despite a much smaller weighting in the S&P 500. Tesla, which performed strongly in 2020, is not included in many sustainable funds in part because it is not part of the S&P 500. However, this could change if the company is added to the index, which some analysts are predicting.

### U.S. Company Green Energy Initiatives

Many U.S. companies have made major investments to cleaner energy sources in the U.S. as well as abroad. More than half of all long-term renewable energy contracts since 2007 in Europe are from U.S. based companies, which helped transform the electricity grid away from coal, gas, and nuclear-powered plants. Alphabet, parent company of Google, is the world’s top corporate buyer of green energy and sourced all of its power globally from renewable energy sources between 2017-18. Further, the company’s purchase of wind and solar energy for its EU data centers was enough to power half of one million homes annually. Microsoft plans to be carbon negative by 2030, meaning taking more carbon out of the air than its operations and supply chains consume. By 2050, Microsoft plans to retroactively eliminate all emissions it produced since the company was founded 45 years ago. Amazon plans to add a fleet of over 100,000 electric vehicles for its Prime service and become 100% green by 2030. Finally, BlackRock, the world’s largest money manager, started moving its actively managed equity and debt investments from thermal coal in 2020. However, BlackRock has more presence in passive funds, which would still be required to invest in coal-based companies if they are included in the benchmarks.

### Sustainable Investments in Fixed Income

While there are currently less available sustainable investment fund options in fixed income than U.S. equities, the underlying bond market has been rapidly expanding. Green bonds were first issued in 2007 and are utilized to fund projects with environmental or climate benefits. The industry has grown five times over the last 5 years, to about \$270 billion in 2019. Green bonds attract lower borrowing costs and hence companies seeking to raise funds for projects have an incentive to tap this market. Currently, there is no global standard of what qualifies as a green bond. A bond issued to finance new renewable energy is considered green, however Spanish energy company Repsol qualified to issue a green bond to fund energy efficiency in chemical and refinery infrastructure. The European Union began a process during June 2020 to establish a green bond standard, although governments could be prone to bias. Hypothetically, countries such as Norway may have more leniency on what qualifies as a green bond, since it is a net oil producer whereas countries that are not energy producers such as France might seek tighter standards. Since there is a gray area of what qualifies as a green bond, a new bond class emerged.

Transition bonds recently emerged as a new bond class and were designed to fund projects to help companies transition to be cleaner and more environmentally friendly. Transition bonds are not issued by companies with high sustainable scores, but rather companies that are in industries that want to be cleaner. Transition bonds have raised \$3.5 billion, according to Bloomberg New Energy Finance (NEF) this year. For example, British gas operator, Cadent, transports methane, which is a carbon gas, which would not fall under the green bond category, but instead qualified as a transition bond. Cadent raised \$560 million to replace parts of its pipeline in England, which was essential to maintaining a cleaner environment.

### Climate Impact of COVID-19

The coronavirus pandemic triggered a \$12 trillion worldwide stimulus to revive economic activity, with about \$5 trillion for climate initiatives, according to Bloomberg NEF in June. As mentioned in the introduction, carbon emissions are expected to decline by 8% this year due to the global lockdowns. Industrial production had been the largest contributor to carbon emissions with 44%, followed by the electric grid (22%) and road and rail (21%). Airlines had the largest drop during the pandemic, reducing capacity by more than 75%, but accounts for less than 3% of emissions. Land travel dropped in half and industrial production dropped by about 35% during the pandemic.

### Conclusion

Climate change such as dangerous hurricane seasons, wildfires in California and Australia, and melting polar ice caps have been a great concern. Last year was the second warmest globally since recordings were available in 1880 and rising temperatures can be attributable to greenhouse gases. Further, the top ten warmest all occurred since 2005, with the top 5 occurring since 2015. William Nordhaus of Yale, awarded the first Nobel Prize for work in climate economics, predicts by 2050, with current emissions trends, a 1% drop of global GDP every year and by 2100, a 4% drop each year. However, the net cost to reach net-zero emissions by 2050 could be even more costly to global economies. Obviously, shutting down the economy reduces carbon, but who wants to go through that again?

The U.S. became the world's largest producer of oil, surpassing Saudi Arabia and Russia, while coal is an important industry in states such as Wyoming and West Virginia. Economies and people rely on these industries for their livelihood and families. Investment in technologies to bring the price of green energy below fossil fuels could be a catalyst for nations to permanently switch. In July of this year, a house panel to Congress sought for the U.S. to adopt policies to make the U.S. carbon-neutral by 2050, including every car sold by 2035 would not emit carbon and the electric grid overhauled by 2040. While climate change might take more time for the world to change its way, sustainable funds continue to bloom. Pension plans may have a growing interest to explore these options. The Department of Labor permits sustainable funds in plans, provided they provide suitable risk-adjusted returns and reasonable fees. In addition, they ideally should fill an asset class lacking in the plan. Unfortunately, most plans have an S&P 500 option, which happens to be the most common sustainable fund option available in the market. Therefore, a sustainable fund could be a complimentary option for most plans to explore in more detail. USI Consulting Group can provide further analysis on sustainable investment options and assess their suitability to your plan.

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