GLOBAL PERSPECTIVES

EM CLIMATE-AWARE INVESTING: FOXES VS. HEDGEHOGS

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Highlights

- Navigating climate-related issues may be increasingly important to emerging market (EM) investors in coming years as compelling evidence of global warming continues to mount.
- Climate-related investment issues hinge critically on political forecasts - namely how quickly politicians will act to curb emissions. But evidence on expert political forecasts is uninspiring.
- Casting a wide net for companies with sustainable business models seems likely to provide better performance than a macro bet against carbon emitters.

Global Warming Evidence is Compelling

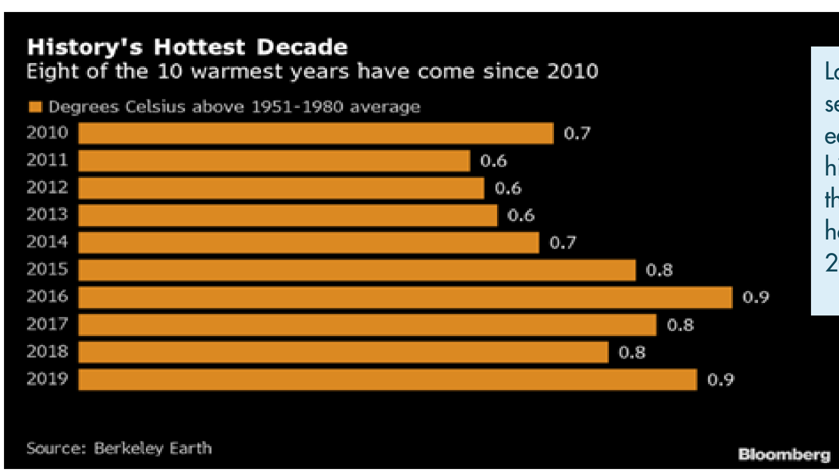
Evidence on global warming has become compelling. Last year was the second warmest for the earth in recorded history. And eight of the ten warmest years have come since 2010 (See Chart 1).

For the first time ever, climate issues dominated the top five positions in the World Economic Forum's recent Global Risks Perception Survey.[1] Notably, the $7 trillion investment manager, BlackRock Inc., announced that it would place sustainability at the center of its investment approach.

Larry Fink, BlackRock's CEO, observed that climate risk has become the top concern of many asset owners.[2] He also warned that climate issues could trigger a massive reallocation of global capital – and perhaps sooner than most anticipate.

Against this backdrop, navigating climate-related issues may be increasingly important to EM investors in coming years.

CHART 1 GLOBAL WARMING EVIDENCE IS COMPELLING



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Foxes vs. Hedgehogs

The ancient aphorism about the fox and the hedgehog comes to mind as we consider the challenge investors face regarding climate change. According to the Greek poet Archilochus, "The fox knows many things, but the hedgehog knows one big thing."

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Phillip Tetlock is a professor of political science at the University of Pennsylvania who has made a career of studying the accuracy of thousands of political forecasts. As summarized in his book, *Superforecasting*, the best forecasters tend to be "foxes", who take many different data points and concepts into consideration, and constantly revise their views based on new information.[3]

The worst forecasters tend to be "hedgehogs", who base their views on one overarching idea or concept. Hedgehogs tend to express their forecasts with utmost certainty, making them popular with media outlets. But hedgehogs tend to do worse than random guessing when making political forecasts.

Will an "Inevitable Policy Response" Trigger a Massive Capital Reallocation?

The research on foxes versus hedgehogs is relevant because climate-related investment issues depend critically on political forecasts. This is very clear in a thoughtful report called *"The Inevitable Policy Response: Preparing Financial Markets for Climate-related Policy/Regulatory Risks"*.[4] It points out that government action to tackle climate change has so far been highly insufficient to achieve the commitments made under the 2015 Paris Agreement. It reinforces BlackRock's warning that a climate-related global reallocation of capital could come sooner than most anticipate:

"The Inevitable Policy Response (IPR) project forecasts a response by 2025 that will be forceful, abrupt, and disorderly because of the delay."

This bold forecast may well be correct. But the word "inevitable" gives pause when it comes to political forecasts. This is especially true since the U.S. has already started to formally withdraw from the Paris Agreement. Also, a recent opinion poll showed that nearly 70% of American respondents would not be willing to pay even $10 per month to fight climate change.[5] And that poll is consistent with the experience of Washington State, where blue-state voters rejected carbon tax initiatives in both 2016 and 2018.

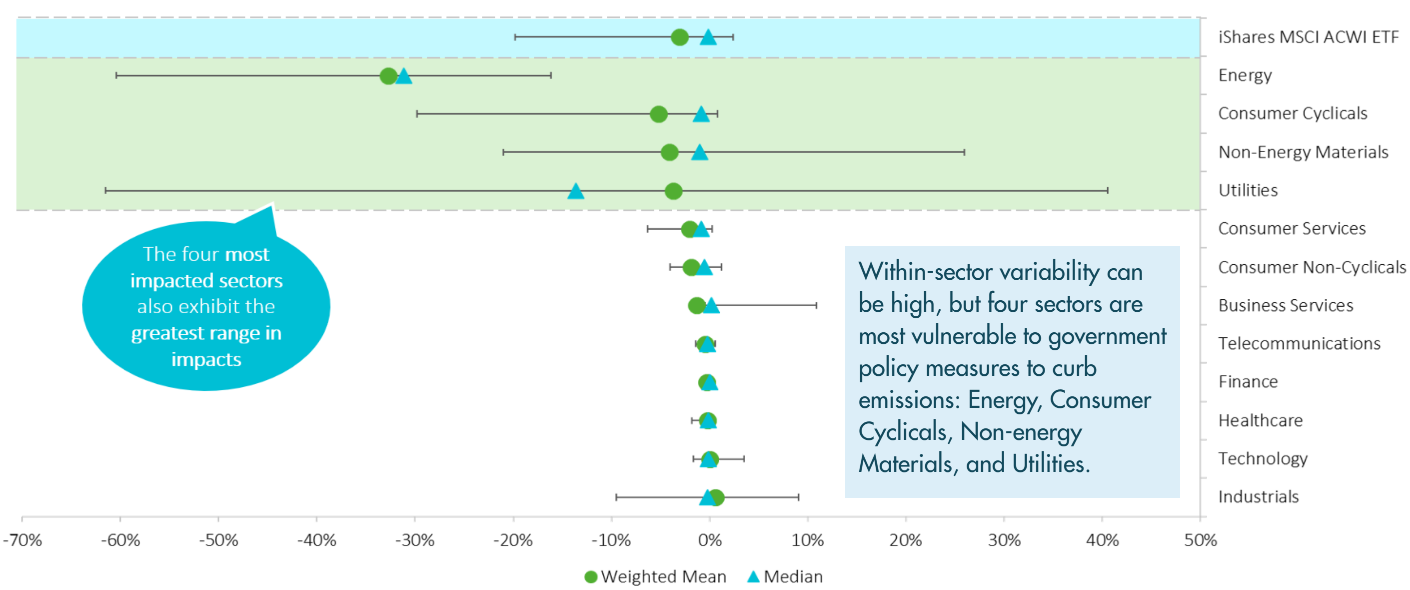
We would also point out that a highly influential climate scientist, Michael Mann of Pennsylvania State University, recently predicted that the rising trend of extreme weather events may level off *for the next several decades*.[6] If correct, this would also suggest that the "inevitable policy response" could be quite delayed.

Hedgehog vs. Fox Climate Strategies

The IPR report is quite useful in highlighting what sectors and industries would face the largest transition risks if governments soon move decisively to cut carbon emissions. Four sectors would be particularly challenged: Energy, Consumer Cyclicals, Non-energy Materials, and Utilities (See Chart 2).

Hedgehog strategies based on the IPR view could range from owning market indexes excluding those sectors, or similar "tilt" products that avoid companies with high

CHART 2 FOUR MOST IMPACTED SECTORS FROM "INEVITABLE POLICY RESPONSE" - ENERGY, CONSUMER CYCLICALS, MATERIALS, AND UTILITIES



Notes: (1) The error bars indicate the 10th and 90th percentile of impact within each sector, (2) based on Vivid Economics Net Zero Toolkit.

Source: The Principles of Responsible Investment, "The Inevitable Policy Response: Preparing Financial Markets for Climate-related Policy/Regulatory Risks," September 2019 and/or non-improving carbon footprints. Index providers like MSCI have been hard at work designing such exclusion or tilt strategies, and we expect to see a proliferation of such products in coming years.

The fox approach to climate-aware investing -- which our EM team advocates -- is to view climate risk as one of many factors that could affect companies' long-term prospects. The goal is to identify companies with sustainable business models that can thrive among a variety of risk scenarios, including climate risk. This is less exciting than "making the call" on a massive re-allocation of capital, as with exclusion or tilt strategies. But we believe it could lead to more robust portfolio results.[7]

Our approach has led us to create EM portfolios that have an estimated carbon footprint at least 70% lower than the MSCI benchmark. But a variety of factors have led to this positioning, not just a climate view:

(1) A focus on sustainable growth industries like IT and e-commerce which enable growth with less reliance on physical resources.

(2) The avoidance of "value-traps" in the Energy, Materials, and Utility sectors – based partly on our commodity price views and partly on our analysts' corporate governance concerns about many of the State-owned Enterprises (SOEs) in those sectors.

(3) A focus on investments in EM insurance companies based on the low-penetration of insurance in many EM nations against a backdrop of rising per capita incomes and assets.

(4) Selective investments in companies that help mitigate climate risks, like electric vehicle makers, battery makers, or Liquid Natural Gas (LNG) producers who provide cleaner energy sources.

As signatories of The Principles for Responsible Investment, we remain committed to incorporating environmental, social, and corporate governance (ESG) factors into our investment decisions and active ownership. As fundamental, bottom-up investors, we will continue to focus on investing in companies with sustainable business models.

Endnotes:

1 World Economic Forum, The Global Risks Report 2020

2 Lawrence Fink, BlackRock Letter to CEOs, January 2020

3 Tetlock, Philip E., and Dan Gardner. Superforecasting: The Art and Science of Prediction. 2015.

4 The Principles for Responsible Investment, "The Inevitable Policy Response: Preparing Financial Markets for Climate-related Policy/Regulatory Risks," September 2019

5 James Rainey, "More Americans Believe in Global Warming, But They Won't Pay Much to Fix It.", NBC News, January 24, 2019

6 Michael E. Mann, "The weather amplifier: Strange waves in the jet stream foretell a future full of heat waves and floods," Scientific American, March 2019

7 We recognize that another objective of exclusion or tilt strategies may be for asset owners to promote political and economic change by starving high carbon emitters of capital. How effective that approach might be and how it relates to the fiduciary duties of most asset managers are separate topics for another day.