LINKING CARBON FOOTPRINT AND FINANCIAL PERFORMANCE

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Do lower carbon emissions translate into financial outperformance?

Arthur Fonck, Equity Fund Manager at La Française Inflection Point, argues that investors are increasingly recognising that companies with the internal policies to address climate change and cut their greenhouse gas emissions, are strategically better positioned, and it is starting to translate into financial performance.

Starting from a global universe, we took a portfolio approach to analysing the impact of carbon footprint measures on financial performance. We constructed sector-neutral unbiased model portfolios, from the most carbon efficient, to the most carbon intensive companies, and the backtested results show that carbon leaders have historically outperformed carbon laggards, based on both absolute and risk-adjusted rates of returns, with an annualized outperformance[1] of 2.3% and a 1.2 Sharpe ratio since 2014. What is even more striking is that this correlation has grown over the past 2 years, as investors and companies increasingly acknowledge carbon emissions as a business issue (Source: La Française Inflection Point research; period considered: three years since 2014).

What is the fundamental rationale behind this result?

As climate change transitions from a regulatory to a business issue, some companies are taking initiatives to mitigate the risks arising from climate change by considering the cost of carbon emissions. Just like a company with unutilised capacity is deemed ineffective, excess emissions are now considered operationally ineffective and a potential liability.

Until recently, responsible investors found that too often, companies focused on maximising profits by meeting regulatory requirements to the bare minimum. This type of short-term focus is the result of ineffective and poor enforcement of carbon emission regulations. Well aware of the risks of climate change, some companies have not waited for regulatory bodies to take action and according to disclosures to CDP, already more than 1000 companies are using internal carbon pricing or preparing to do so by 2018.

Carbon emission reduction can sustain profitability in the long-term

When emissions bear a cost on an income statement, it helps investors to highlight inefficiencies and reward those companies that are cutting-down their carbon emissions. As such, La Française's carbon neutral investment strategy recognises the impact that lower carbon emissions can have on sustaining long-term profitability. When we value companies, we adjust for new regulations that will price the ton of carbon emissions.

The question of putting a price on carbon has gained public traction as a means to reduce emissions and drive investment towards cleaner alternatives as well as energy savings. Some companies have already taken steps to implement internal prices for carbon: LVMH has recently increased its internal price for carbon to €30/ton; Adobe charges each business unit for costs associated with energy consumption in order to favour carbon efficiency projects, reduce costs and mitigate business risks.

Combining carbon efficiency and carbon transition, yields even better returns

We examined to what extent a change in a company's carbon footprint has been a predictive indicator of financial performance. Using the same portfolio construction methodology, we found that companies that are reducing their carbon footprint year-over-year in addition to being carbon leaders have outperformed significantly by an annualized 6.3% rate of return and a 1.3 Sharpe ratio over the same period.

La Française's carbon neutral investment strategy aims to identify those companies that are making the effort to transition to a low-carbon economy and that have the strategic positioning that will yield relative financial outperformance in the future.

Wal-Mart, as a logistics and transportation intensive business, is a company that is seeking to reduce its emissions to mitigate the potential negative impact of costs on its value chain. Leveraging on its scale, Wal-Mart launched “Project Gigaton” and set a new goal to reduce emissions by 1 gigaton by 2030 by investing in technology to reorganise its value chain. The company is taking the strategic bet that it will reduce emissions in a manner that is difficult for smaller competitors to replicate. While Wal-Mart is not the most carbon efficient retailer today, its strong commitment to reduce the emissions of its stakeholders, as well as those it generates itself, makes it a leading transitioning company.

Similarly, e-commerce, and its proliferation of small shipments, needs to find operational responses to address climate change. Logistics companies are implementing more-efficient deliveries, switching to alternative fuel vehicles and optimizing schedules to reduce traffic delays. UPS, which has reduced the distance driven by its drivers by 210 million miles and achieved a 210,000 metric ton reduction in CO_2 emissions, has realized annual cost savings of US$400 million (Source: 2016 UPS Corporate Sustainability Report).

Conclusion

Judging from the success of the One Planet Summit in Paris, the misconception that investors do not consider environmental factors in their investment decisions has been disproved. Investors are starting to realize that companies who fail to reduce emissions face increasing competitive disadvantage that could severely affect the valuations of companies.

Initiatives such as the carbon pricing corridors already create benchmarks for investors seeking to assess climate-related value at risk. Alongside more transparency and disclosure from companies this should increasingly make for climate informed investment decisions and widen the performance gap between carbon leaders and laggards.

[1]Simulated past performance is not a reliable indicator of future performance. There are risks associated with an investment in equities which include but are not limited to: currency, equity, emerging markets, investment fund, management, market model, liquidity and operational.