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No sector left behind

Introducing the Aviva Investors Climate Transition Global Equity strategy

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It takes Aviva Investors

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Key takeaways

As the effects of climate change become more pronounced, and governments, societies and companies act to address the crisis, the accelerating climate transition will transform the investment landscape.

The transition will lead to structural changes across all industries. To avoid the risks and take full advantage of the opportunities, we believe equity investors must look beyond "green" sectors such as renewable energy and also invest in companies leading the transition effort, and those developing products along with services that help the world adapt to and mitigate the worst effects of climate change.

Through this approach, the Aviva Investors Climate Transition Global Equity strategy aims to drive progress towards a more sustainable future and deliver enhanced returns for investors.

Introduction

Climate change represents arguably the world's greatest long-term challenge. To meet the Paris Agreement target of restricting global warming to well below two degrees above pre-industrial levels, and ideally 1.5 degrees, we need to see a 50 per cent reduction in emissions every decade from 2020 to 2050; this equates to a decline of more than seven per cent per year.

Achieving this will require a significant increase in spending on products and services that can help society decarbonise and adapt to a warmer climate. Estimates of the capital required vary from $3.5 trillion to $9.2 trillion a year.[1,2] The scale and pace of change needed for the transition to a low-carbon and climate-resilient economy will impact every company and every sector throughout their value chains, bringing significant investment risks and opportunities.

The scale and pace of change needed for the transition to a low-carbon and climate-resilient economy will impact every company and every sector

Companies are already experiencing the economic and physical effects of climate change. We expect the financial impacts will accelerate further, driven by regulation, technical progress and growing investor and consumer activism. We believe these forces will lead to greater dispersion in performance between transition leaders, those working proactively to ensure they are on the right side of these trends, and laggards, whose business models could come under threat due to their failure to respond.

To effectively support and ultimately profit from the transition to a lower-carbon economy, investors will need to look beyond simple rules-based exclusions and instead focus on hard-to-abate but economically vital sectors as they seek to reduce their emissions, alongside companies whose products and services can help societies mitigate climate change and adapt to its effects.

Many companies claim they stand to benefit from the climate transition. While this may be true for some, firms in traditionally "green" industries will also face stern headwinds in an increasingly competitive and complex business environment. Not all solar-power generation companies or electric-vehicle (EV) manufacturers will succeed, even if these sectors are projected to see demand growth in the aggregate. To find attractive returns, investors have to look beyond the obvious beneficiaries and assess how the climate transition is transforming business models across sectors.

The Aviva Investors Climate Transition Global Equity strategy adopts an active, fundamentally focused investment approach to identify companies that can translate their best-in-class climate credentials into stronger growth and profitability. In doing so, the strategy also aims to drive progress towards a more sustainable future and deliver enhanced returns for investors.

Drivers of the climate transition

Three key factors will act as catalysts for the transition to a lower-carbon economy. These will influence companies' financial performance and the ability of investors to differentiate between climate leaders and laggards.

1 Regulation and government policy

2 Technical progress

3 Investor and consumer pressure

Regulation and government policy

Over 200 countries have signed up to the Paris Agreement. Meeting Paris targets requires net-zero greenhouse-gas (GHG) emissions by 2050; according to Net Zero Tracker, 128 countries now have net-zero commitments, which cover 88 per cent of global GHG emissions and 92 per cent of GDP.[3]

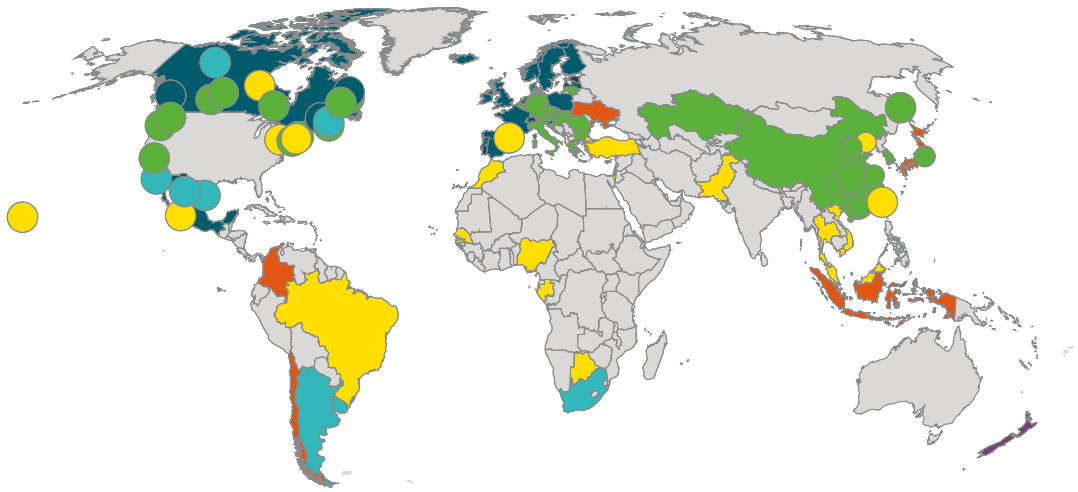
In addition to new policies at national and international levels, many regions and municipalities have taken their own steps to reduce emissions. These include more than a dozen US states, such as California, which aims to achieve net zero by 2045.

> Many regions and municipalities have taken their own regulatory steps to reduce emissions

Government efforts to reduce emissions are likely to translate into increased regulatory burdens for companies. Those with multinational operations will be exposed to a patchwork of regulations – such as carbon taxes, emissions-trading schemes (ETS) and other fossil-fuel taxes – designed to increase the cost of emissions and stimulate action by the private sector to reduce them.

For example, carbon-pricing schemes now account for over a fifth of all emissions, with many more such initiatives under consideration or due for implementation (see Figure 1).

Figure 1. **Map of regional, national and subnational carbon pricing initiatives**



- ETS implemented or scheduled for implementation
- ETS or carbon tax under consideration
- ETS implemented or scheduled, ETS or carbon tax under consideration
- Carbon tax implemented or scheduled for implementation
- ETS and carbon tax implemented or scheduled
- Carbon tax implemented or scheduled, ETS under consideration

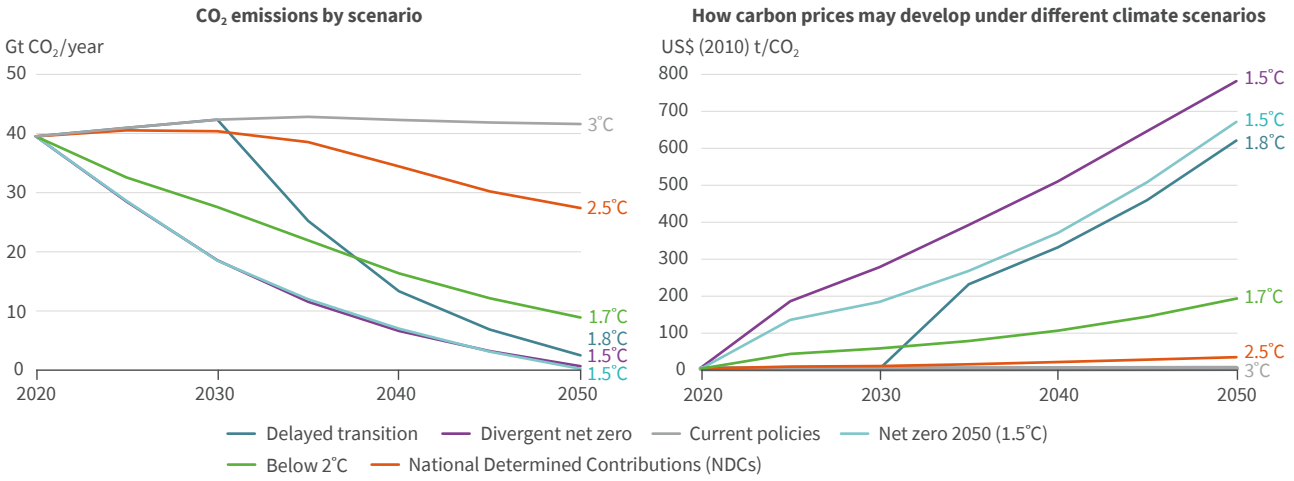
Source: World Bank Carbon Pricing Dashboard, 2022.[4]

Whilst current global carbon prices have not yet reached the level needed to encourage a widespread switch away from fossil fuels, the price of carbon is expected to increase significantly between now and 2050. This is likely to have a material impact on company profitability.

The scale and pace of the increase in carbon pricing will depend on the speed of emissions reductions, as set out in scenarios developed by the Network for Greening the Financial System (Figure 2). If action is delayed, carbon prices will likely have to be sharply hiked to keep net-zero targets in view. Figure 3 illustrates the substantial risk rising carbon prices pose to revenues among companies on each regional market index under a moderate climate change action scenario.[5,6]

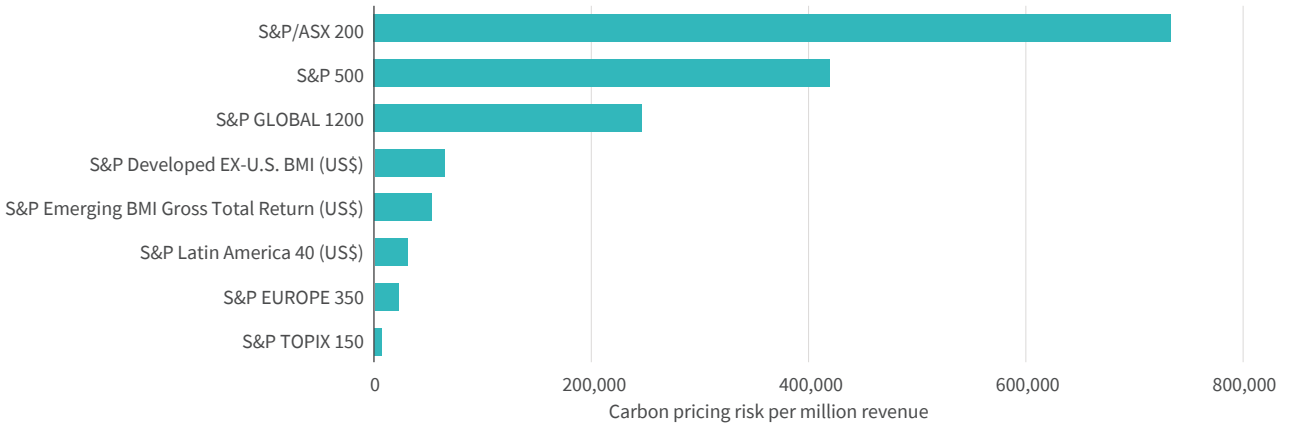
> The scale and pace of the increase in carbon pricing will depend on the speed of emissions reductions

Figure 2. **Scenarios for climate policy, emissions and temperatures**



Note: Full explanation of scenarios and timelines available in references.
Source: Network for Greening the Financial System, June 2021.[7]

Figure 3. **Average regulatory transition risk by index (moderate climate change action scenario, US$)**



Source: S&P Global, 2019.[8]

Technical progress

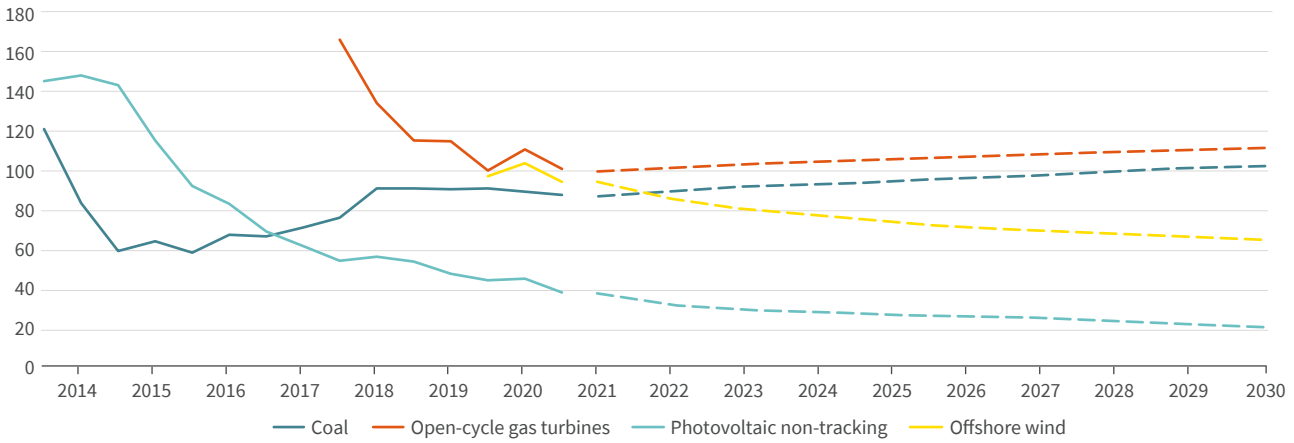
While tighter regulation provides a "push" factor, economics and technical innovation are the key "pull" factors for the transition. The adoption of more sustainable practices and modes of production increasingly makes sense, environmentally and economically.

A prevalent example is in the automotive sector, where the costs of production and price of EVs are set to fall below those of traditional internal combustion engines (ICE). In China, EVs are already cheaper. Combined with lower ownership costs, these dynamics should see demand accelerate.

> While tighter regulation provides a "push" factor, economics and technical innovation are the key "pull" factors for the transition

The economics of the automotive industry are widely understood, but similar dynamics are playing out in other sectors. Take energy: in the US, for example, the cost of electricity generated from renewable sources has fallen considerably over the last ten years and is expected to continue declining relative to fossil fuels (see Figure 4).

Figure 4. **Cost of electricity by power source ($/mwh)**



Source: BloombergNEF, 2022.

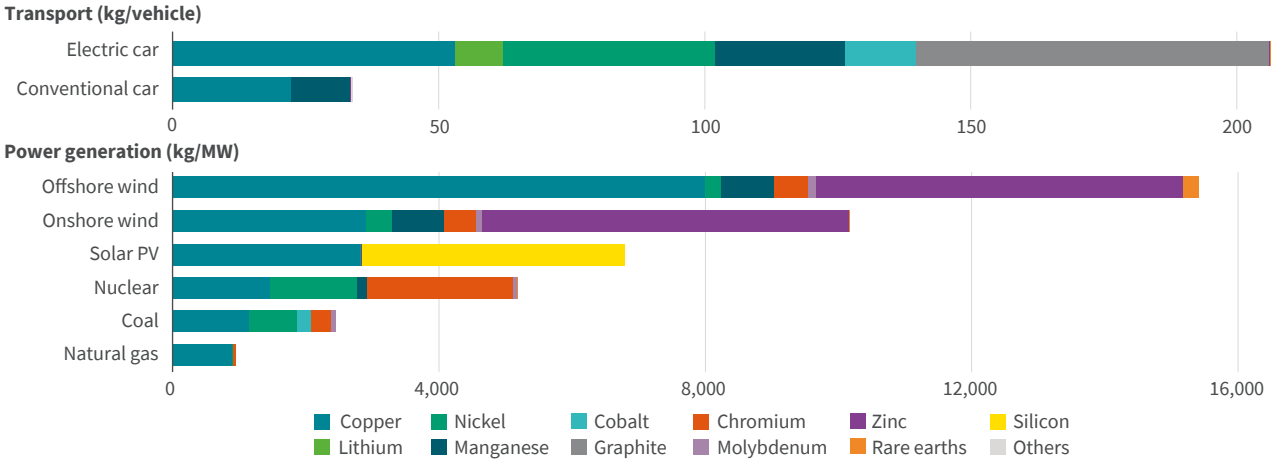
The effects of these developments will ripple far beyond "green" sectors most obviously aligned to the transition. For instance, some mining companies could benefit from rising demand for metals such as copper, which are required for the technologies that enable electrification (see Figure 5).

> The effects will ripple far beyond "green" sectors most obviously aligned to the transition

At the same time, these firms will come under increasing pressure to decarbonise their own operations by replacing diesel-powered machinery. This should create opportunities for industrial equipment manufacturers, such as Sweden-based Epiroc, which develops electric-powered alternatives: achieving 80 per cent electrification of the underground mining fleet by 2035 would require a tenfold increase in production and sales of electric equipment in the next decade.

In addition, electrification should bring advantages across the mining sector as a whole: electric machinery can carry weightier loads and removes the need to invest in ventilation systems to protect workers from diesel fumes, enabling cost reductions and productivity benefits.[9]

Figure 5. **Minerals needed to support the energy transition**



Source: International Energy Agency, 2020.[10]

Investor and consumer pressure

Companies are not judged solely on the products and services they sell or their financial results. Investors and consumers are increasingly paying attention to the effects of companies' operations on the environment and wider society – and advocating for faster progress.

Purchaser pressure can be seen through business-to-business and business-to-consumer interactions. For example, tech giant Apple has set science-based targets (SBTs)[11] that include reductions in "Scope 3" emissions associated with its supply chain. To help meet these targets, it has called for its manufacturing partners to switch to 100 per cent renewable energy by 2030; it has consequently won commitments from 200 suppliers, including major manufacturers such as SK hynix and TSMC, to power all Apple device production with 100 percent renewable energy.[12]

On the consumer side, a recent survey by Deloitte shows a clear opportunity for companies that act on environmental issues – 23 per cent of consumers say they will switch to buying products from an organisation that shares their values on the environment – and the effects are already evident across sectors.

Shifts in consumer preferences are reshaping the food industry, for instance, as the climate and biodiversity impacts of intensive farming become clear, along with the health risks associated with the consumption of red meat.

Research shows growing demand for greener, healthier food products, especially in the US and Western Europe, is driving growth in alternative proteins. Some estimates suggest these alternatives could capture ten per cent of the global meat industry by 2030 – up from less than one per cent in 2017 – to create a market worth $85 billion.[13] A recent report from Boston Consulting Group finds the shift to alternative proteins will save more than one gigatonne of CO_2 emissions by 2035, equivalent to the near-total decarbonisation of the aviation or shipping industries.[14]

$85bn

Projected size of global alternative-protein market by 2030

Along with business and consumer pressure, investor demands of companies in relation to climate and other environmental, social and governance (ESG) factors have significantly increased. We expect this to continue, either through direct engagement between investors and company management to develop and accelerate their climate ambitions, or via shareholder resolutions.

Investors are increasingly viewing climate-related risks as material to the performance of companies on both sides of the balance sheet. Climate change and the transition to a lower-carbon economy can present risks to a company's business model – or the potential for significant growth. Tighter regulation and changing economic and technological developments could leave companies with stranded assets or far higher operating costs relative to peers.

Investors are increasingly viewing climate-related risks as material to the performance of companies on both sides of the balance sheet

But investors can also exert significant influence when it comes to climate and other sustainability issues, including by encouraging investee companies to adopt SBTs. In doing so, they can help ensure their capital-allocation decisions have maximum influence on efforts to tackle climate change (see boxed text). As more companies set SBTs and act on them, others will have to follow; those refusing to act will stand out, potentially putting them at a competitive disadvantage.

Why do we focus on science-based targets (SBTs) rather than net-zero objectives?

While 1,833 companies have announced their intention to reach net zero, few have target dates. This reflects a tendency to acknowledge climate ambitions without knowing how to achieve them. This is why we support the more practical orientation of near-term SBTs, which specify by how much and how quickly firms will reduce emissions.

There are significant differences between SBTs and net-zero targets. For example, the latter allow residual emissions to be neutralised through carbon dioxide removal (CDR) mechanisms, like carbon offset schemes. CDRs can be used as a "fix" to align an emissions pathway with the desired net-zero outcome. But there are growing concerns about whether there will be enough capacity to deliver genuine carbon reductions, either through natural sequestration (forestry, soil carbon) or emerging technological solutions. SBTs do not allow abatement targets to be met through CDRs in any timeframe.

By setting SBTs, companies signal they are taking an active, forward-looking view. Those including Scope 3 emissions will encourage suppliers and users of their products to curb their own carbon footprints. Eventually, suppliers that fail to act may struggle to hold on to customers.

For portfolio managers, cumulative emissions data offer little insight. Normalised carbon footprints (which measure emissions in tonnes of carbon dioxide per millions of dollars/euros invested adjusted for equity ownership) or carbon intensity (measuring total carbon emissions relative to revenue) have their own challenges; for example, oil and gas producers will see carbon intensity fluctuate with energy prices, despite absolute emissions remaining largely unchanged.

In contrast, SBTs reveal how companies are managing risks and planning to develop climate resilience across their value chains. For investors, they can also mean allocation decisions have greater impact, because the impetus to decarbonise can trickle down the supply chain to companies in which the manager does not hold a stake.

A transition-focused investment approach

While the growth in climate- and sustainability-focused investing is encouraging, there are several potential drawbacks in the way ESG funds traditionally allocate capital. Many managers focus exclusively on companies providing technologies designed to tackle climate change – such as EV manufacturers or renewable energy providers. But it is naïve to think such companies can deliver the transition on their own.

Investors who want to maximise returns alongside their sustainable outcomes can do things differently. By adopting a forward-looking, transition-focused approach, investors should be better able to price and capture opportunities across a wider range of sectors and provide a broader range of companies with the means to enable their transition. In doing so, they should be able to achieve their financial objectives while making a meaningful difference in the battle against climate change.

Investing in the climate transition offers investors significant opportunities to profit from the regulatory, technological and consumer-behavioural shifts occurring across markets. As understanding of how the transition to net zero is likely to impact business models and profitability becomes more widespread, active managers will be able to identify and monetise investments in companies well positioned for a lower-carbon economy.

Investing in the climate transition offers investors significant opportunities to profit from the regulatory, technological and consumer-behavioural shifts occurring across markets

Alongside the potential rewards, a growing body of evidence and research shows the financial risks posed by the direct and indirect consequences of climate change. A recent study by S&P found almost 60 per cent of companies in the S&P 500, and more than 40 per cent in the S&P Global 1200, hold assets at high risk of physical climate change impacts. These impacts may involve the destruction of valuable assets due to extreme weather events such as floods or wildfires. But climate change will also disrupt production and supply chains and necessitate higher spending on adaptation through increased investment or operating expenditure (for example, on air conditioning to keep employees comfortable in higher temperatures). Companies will also have to grapple with the knock-on effects of a wider deterioration in macroeconomic conditions.[15]

Figure 6. **Index constituents with assets at high physical risk (moderate climate change scenario)**

	Number of companies with assets at high physical risk on a least one indicator	Market cap of companies with assets at high risk US$ trillion	Revenue of companies with assets at high risk US$ trillion
S&P/TOPIX 150	40 (27%)	$1.3 (42%)	$2.1 (55%)
S&P/ASX 200	88 (44%)	$0.9 (89%)	$0.4 (82%)
S&P GLOBAL 1200	521 (43%)	$27.3 (66%)	$16.6 (66%)
S&P EUROPE 350	101 (29%)	$4.3 (52%)	$3.2 (48%)
S&P 500	297 (59%)	$18.0 (72%)	$9.0 (74%)

Source: S&P Global, 2019.[16]

Companies are increasingly recognising physical and transition climate risks. According to CDP,[17] 53 per cent of companies that report to it identify climate-related risks that could have a substantial financial or strategic impact. Among the world's largest 500 companies by market capitalisation, risks valued at over $970 billion were identified, half of which were reported as "likely", "very likely" or "certain", with one quarter linked to asset impairments or write-offs. At the more extreme end of the spectrum, a study from the Bank of England (BoE) warned as much as $20 trillion of assets could be at risk of becoming stranded.

No sector left behind

Climate leaders and laggards exist across all sectors. Our transition-focused approach attempts to identify climate leaders in every industry, rather than solely those in low-carbon sectors.

Investors may consider the most appropriate response to the climate crisis is to exclude the most heavily polluting sectors and concentrate investments solely on low-intensity clean-tech industries developing "solutions-based" opportunities, such as renewable energy and EVs. But this approach fails to fully appreciate the scale and breadth of the challenge.

The value chains of all companies will be impacted by efforts to decarbonise or the physical impacts of climate change. Transition risks will vary by industry, and even by sub-industry, creating greater dispersion at a company and sector level. Companies within high-emission sectors will have to transition and require capital to do so.

The value chains of all companies will be impacted by efforts to decarbonise or the physical impacts of climate change

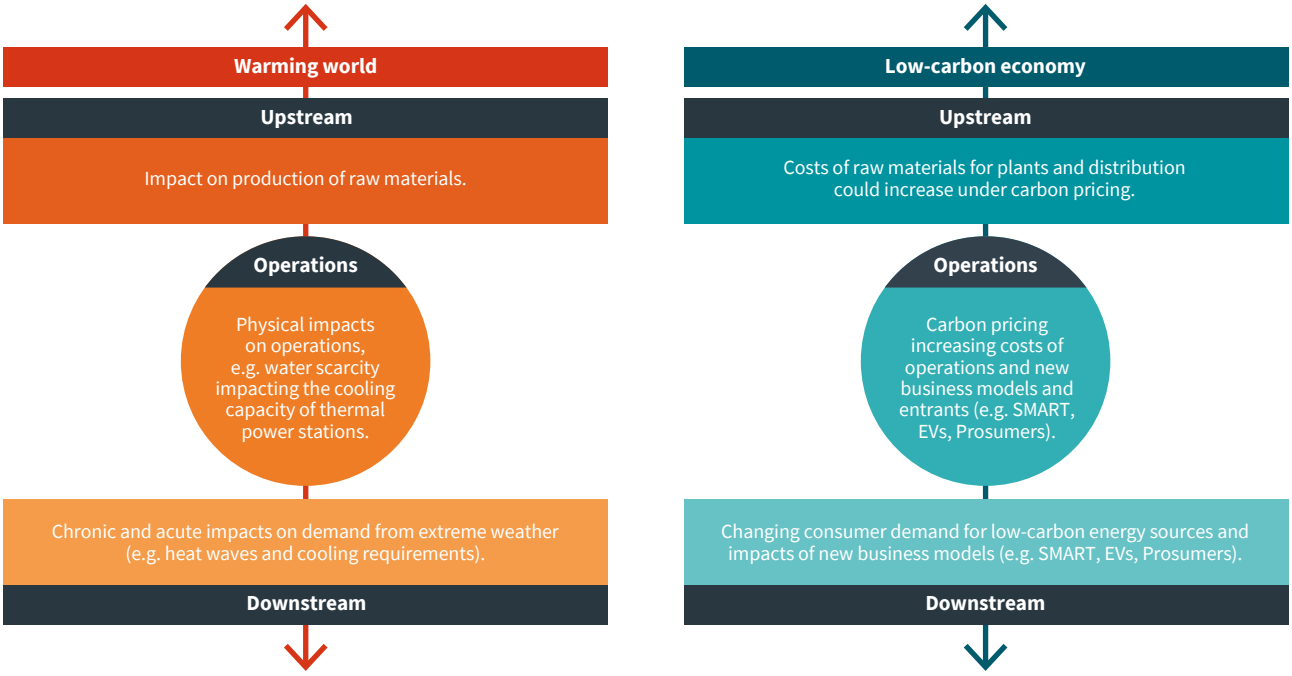
For some businesses, the transition will be capital-intensive and may erode margins and profitability. Others will use capital to make their business models more resilient, less cyclical and ultimately more profitable, while also reducing carbon intensity. Through active ownership, investors can use their influence on company management to accelerate the transition via engagement and benefit from exposure to companies able to turn their focus on sustainability into profitable growth.

Investing in the climate transition in this way is far from straightforward, however. For a start, it requires a deep understanding of the risks facing different industries, as well as individual companies. For example, utilities face much higher decarbonisation risk than healthcare companies, but the impact will vary: water companies face higher physical risk from water scarcity, while electricity producers are exposed to greater carbon regulatory risk. At the company level, one automaker may be further advanced than another in terms of transitioning to EVs.

In the food industry, Swiss-based conglomerate Nestlé is a good example of a company that has taken steps to understand and mitigate climate-related risks. The firm acknowledges climate breakdown is a threat to the future of its business and has a validated near-term target of business alignment with 1.5°C approved by the Science-based Targets Initiative. Additionally, Nestlé has committed to a target of net-zero emissions by 2050. To deliver on these pledges, it has made various assurances: it will switch to more plant-based food and beverage options, with more climate-friendly ingredients, and use more sustainable packaging materials.

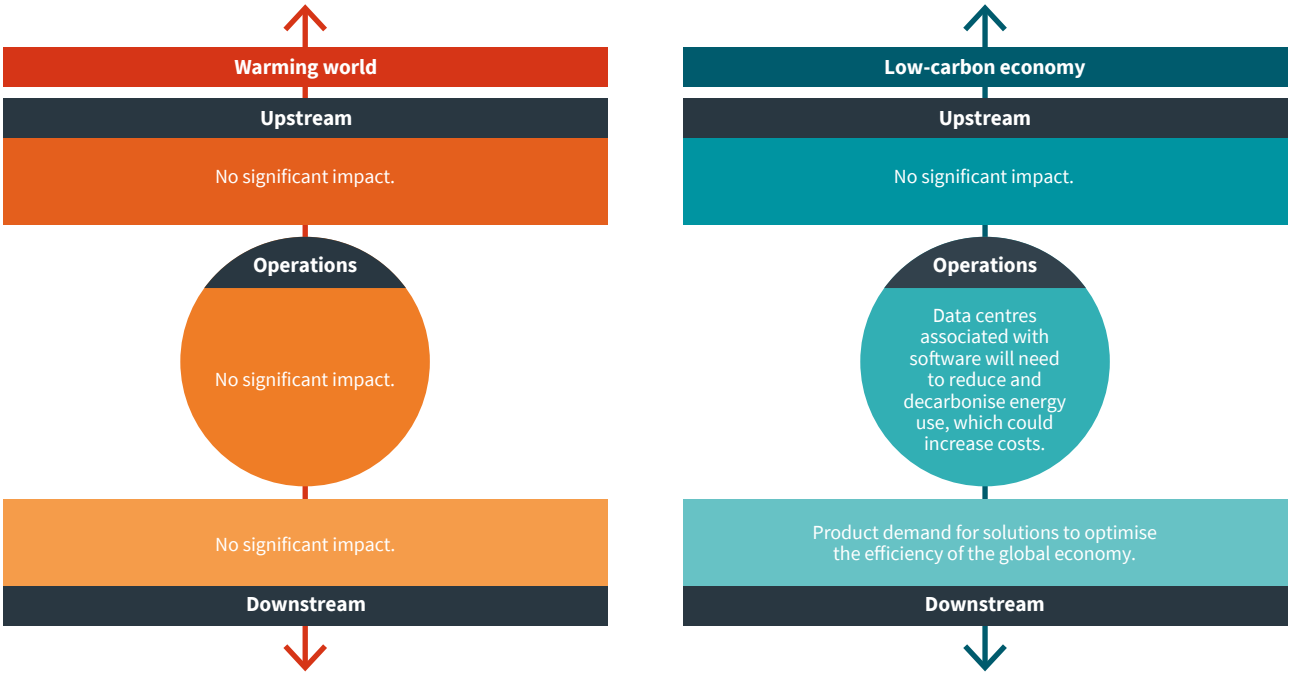
The examples in Figures 7 and 8 show how the value chains for two other industries could be impacted by higher temperatures and the transition to net zero.

Figure 7. **Value chain impact of high-risk sector thematic: Electric utilities**



Source: Aviva Investors, May 2023.

Figure 8. **Value chain impact of low-risk sector thematic: Application software**



Source: Aviva Investors, May 2023.

The role of solutions

While the potential to profit from companies' transition to a lower-carbon economy represents a huge opportunity, the reality is that global temperatures have already risen dramatically and are likely to rise further. This is leading to growth among companies that can help society either mitigate the impacts of climate change or adapt to a warmer world.

The United Nations Environment Programme (UNEP) estimates the annual cost of adaptation will be between $140 billion and $300 billion by 2030, rising to $500 billion by 2050. However, only five per cent of climate change investment is currently spent on adaptation efforts. Companies whose products and services are focused on mitigation and adaptation stand to benefit from a huge increase in public and private investment as companies and countries look to improve climate resilience and preparedness.

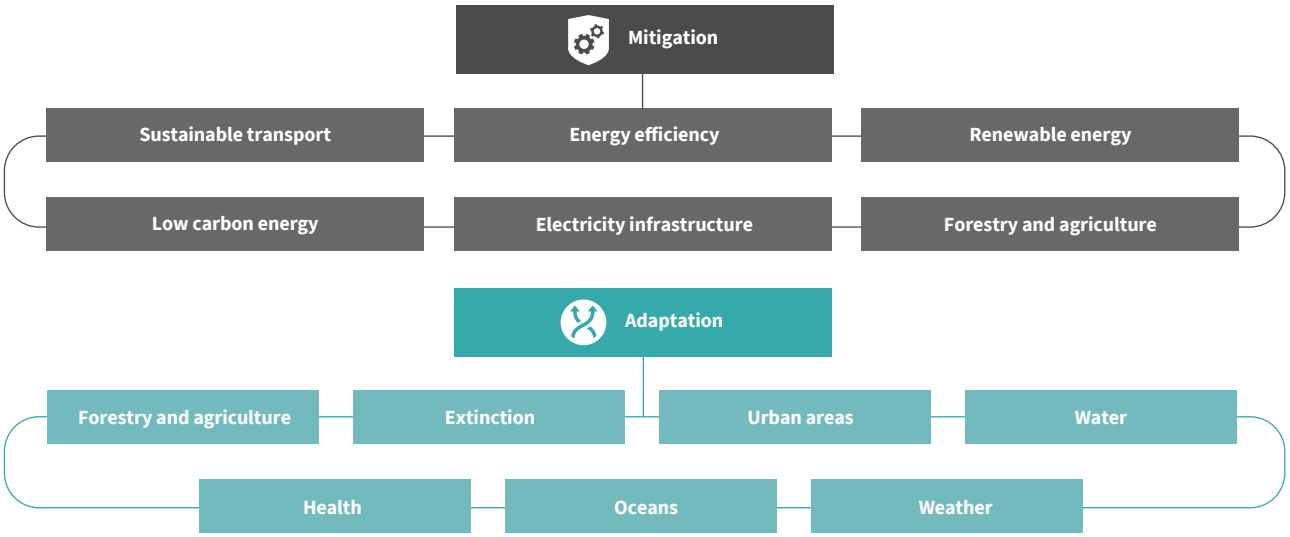
As active investors, our focus is on identifying companies that can turn demand for mitigation and adaptation products and services into a sustainable competitive advantage. One example is chemicals company Sika, which is developing innovative products for use in construction, helping customers to avoid or reduce direct and indirect carbon emissions.

> Our focus is on identifying companies that can turn demand for mitigation and adaptation products and services into a sustainable competitive advantage

On the adaptation side, the knock-on effects of climate change are creating surprising dynamics. For example, a warming climate is enabling a longer breeding season for pest species. Pest-control firm Rentokil is likely to be well-positioned for this environment. The company is completing the acquisition of Terminix, which will make it the leader in North America; in this market, both residential and commercial pest control tends to be preventive, with customers taking subscriptions to pest-control services. This offers Rentokil the prospect of recurring revenues.

It is important for investors to be attuned to these sorts of sector-specific trends. Some companies will have a stronger barrier to competition because of the private and public investments they have already received; others will see their initial advantage competed away over time.

Figure 9. **Identifying companies providing solutions for climate change mitigation and adaptation**



Source: Aviva Investors, May 2023.

Doing well by doing good

Climate change poses a clear and present danger to our environment and the global economy. As governments, societies and companies act to address the crisis, the accelerating climate transition will transform the investment landscape.

The transition will lead to structural changes across all industries. To avoid the risks and take full advantage of the opportunities, we believe equity investors must look beyond "green" sectors such as renewable energy. A more holistic strategy, which encompasses the transition efforts of companies in hard-to-abate sectors, as well as firms developing products and services that help the world adapt to and mitigate the worst effects of climate change, is better suited to the scale of the shift.

We believe equity investors must look beyond "green" sectors such as renewable energy

Unlike exclusion-based strategies that focus solely on solutions-based opportunities, this kind of forward-looking approach has the potential to identify attractive investments across the whole economy – and to deliver tangible environmental benefits by helping companies effect a transition to a more sustainable future. The objective is both simple and achievable: to do well by doing good.

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11. SBTs specify by how much and how quickly companies need to reduce their greenhouse gas emissions. They simultaneously help firms by providing a clearly defined path to achieving this. Targets are considered "science-based" if they are in line with what the latest climate science deems necessary to meet the goals of the Paris Agreement – limiting global warming to well-below two degrees Celsius above pre-industrial levels and pursuing efforts to limit warming to 1.5 degrees. See: Science Based Targets, 2023.
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Key risks

Past performance is not a guide to future performance.

Counterparty Risk

The strategy could lose money if an entity with which it does business becomes unwilling or is unable to meet its obligations to the strategy.

Currency Risk

The strategy is exposed to different currencies. Derivatives are used to minimise, but may not always eliminate, the impact of movements in currency exchange rates.

Derivatives risk

Investments can be made in derivatives, which can be complex and highly volatile. Derivatives may not perform as expected, meaning significant losses may be incurred.

Derivatives are instruments that can be complex and highly volatile, have some degree of unpredictability (especially in unusual market conditions), and can create losses significantly greater than the cost of the derivative itself.

Emerging markets risk

Investments can be made in emerging markets. These markets may be volatile and carry higher risk than developed markets.

Illiquid securities risk

Some investments could be hard to value or to sell at a desired time, or at a price considered to be fair (especially in large quantities), and as a result their prices can be volatile.

Investment risk

The value and income from the strategy's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the strategy will achieve its objective and you may get back less than you originally invested.

Sustainable Investing Risk

The level of sustainability risk to which the strategy is exposed, and therefore the value of its investments, may fluctuate depending on the investment opportunities identified by the Investment Manager.

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