Climate Change – The Time is Now

There is a growing awareness that the planet's ecosystem is being irreparably damaged by the unsustainable relationship between society and the global economy on the one hand and energy sources and greenhouse gas (GHG) emissions on the other.

The necessary transition requires shifts away from fossil fuel-based production to a reliance on green and renewable energy sources. This will require policy commitments from government, significant innovation and investment leading to meaningful shifts in production methods and an acceleration of changes in consumer preferences.

None of this is new news. In 2006 Nicholas Stern led a team of analysts who produced the influential report "The Economics of Climate Change". In that report it was noted that:

> ***"Climate change threatens the basic elements of life for people around the world***
>
> ***– access to water, food production, health, and use of land and the environment."***

That was written 15-years ago. What has changed more recently has been the growing sense of urgency and calls for action given:

- The increased frequency and intensity of extreme weather events, from floods to wildfires;
- Evidence of rising sea levels and increased incidence of coastal flooding;
- The rising cost of broken infrastructure and climate related disruptions in global supply chains, especially food production;
- Increased evidence of climate related migration – in 2018 the World Bank estimated that without urgent global action on climate change, by 2050 there would be more than 143 million internal climate migrants across sub-Saharan Africa, South Asia and Latin America, increasing the risks of regional conflict;
- The size of Covid-related fiscal stimulus, and the need for that investment to line up with long-term strategic objectives of mitigating and adapting to the realities of climate change;
- The general elevated sense of urgency from the public that politicians and firms have been increasingly unable to ignore.

These factors have shifted the dial from endless debate about the validity of the science to more meaningful action.

A global problem needs a global response…

Climate change is a global phenomenon, requiring co-ordinated action on a global scale. This is made challenging by the differing circumstances within each country, including the severity of changed weather patterns, the ability to afford the costs of climate change mitigation and adaptation, and the political will to act.

The Paris Agreement on climate change is the best chance of global collaboration on climate change, replacing the Kyoto protocol which was narrower in scope as it only captured developed economies while some of the biggest emitters were (and remain) developing countries. The United Nations agency, the "Intergovernmental Panel on Climate Change (IPCC)" has, for over thirty years, established the scientific standards and proof-points for a world where the trade-off between the environment and economic growth is always politically fraught. As evidence inexorably mounted, even the more hesitant nations came on board as the will for change began to outweigh the vested interests of polluters.

The Paris Agreement was signed by 196 countries in 2015. It has recently enjoyed a boost to the prospects of its success with new United States President Joe Biden returning his country to the fold following the decision of his predecessor to take the United States out of the agreement.

The Agreement aims to substantially reduce global greenhouse gas emissions in an effort to limit the global temperature increase in this century to 2 degrees Celsius above pre-industrial levels, while pursuing the means to limit the increase to 1.5 degrees.

Meeting the challenges requires multi-lateral agreement and collaboration. The agreement includes commitments from all major GHG emitting countries to cut their emissions and strengthen those commitments over time.

Importantly, the agreement creates pathways for developed economies to assist developing economies. This recognises that developing economies are in the weakest position to invest in mitigation and adaptation solutions, creating a loss of competitiveness, contributing to increased inequality and a lower quality of life when compared with the developed world.

More recently the G7, itself bolstered by the return of the United States in a constructive presence, agreed on further steps with respect to climate change including the commitment of US$100 billion from public and private sources to support developing countries in their climate change strategies. Progress now needs to extend to the G20 with that grouping including some of the developing world's highest GHG emitters.

History is littered with examples of global agreements that fall over as solutions require tough actions for politicians at home. This agreement creates a framework for the transparent monitoring, reporting, and ratcheting up of countries' individual and collective climate goals.

...and local action.

New Zealand signed the Paris Agreement in April 2016. This was ratified by Parliament in October 2016. Ratification committed New Zealand to:

- having an emissions reduction target;
- regularly report on our emissions and how we are tracking towards meeting our targets;
- provide financial support to assist developing countries mitigation and adaptation efforts; and
- develop a plan for adaptation.

In June 2021 the much anticipated final advice from He Pou a Rangi (the Climate Change Commission), Ināia tonu nei: a low emissions future for Aotearoa, was delivered to the Government.

The Report is a substantial piece of work that is focused on advising the Government on domestic emissions budgets and whether the budgets will put NZ on a path to meet Paris Agreement targets (Nationally Determined Contributions).

While it provides a Demonstration Path to get to these targets, it is up to the Government to develop the Emissions Reduction Plan by the end of the year.

It is an inclusive document, weighted heavily with the importance of a just transition and a sustainable low emissions economy past 2050.

The Emissions Reduction Plan is the first step. For many of the 33 recommendations, there are associated requirements for policies, strategies, plans, reports, and progress indicators to encourage emission reductions and disincentivise large emitters — each with a deadline ranging from 2022 to the end 2024.

The risk is we lose a few years of progress awaiting those policies, plans and strategies. Equally, there is much discussion around funding incentives to encourage energy switching and innovation. The short-term risk is businesses may decide not to do anything now before emissions are calculated or funding initiatives are clarified so that they don't miss out on incentives or recognition for emission reduction.

It is now over to Government to decide whether to accept the advice and to show how it will shape climate action in Aotearoa. They have until 31 December 2021 to set the first three emissions budgets out to 2035 and release the country's first emissions reduction plan detailing the policies it will use to achieve the budgets.

In the meantime the Emissions Trading Scheme and more specifically the price of carbon will continue to play a pivotal role in the transition. The price signals provided by the price of carbon is already seeing consumers and producers adapt. The incentives for changed behaviors, as well as the development of technological solutions, will only increase as the price of carbon continues to rise.

We can't just rely on Government to do this for us

We cannot rely on just the Government to make the necessary changes and adaptations. There are important roles for consumers, firms and investors.

Consumers need to play an important role in reducing emissions and slowing climate change by making more environmentally conscious decisions and purchases. Making better consumer choices starts with understanding your own carbon footprint and getting access to information. Asking the right questions before purchasing will lead to better choices: What is this made of? Where it is from? But consumers also need to aware they may have to pay more for those purchases. Higher quality, emissions-lite products may not be as cheap as higher polluting options. Consumers also have important decisions to make around things like transport options, not just whether to buy an electric vehicle but also greater use of public transport.

For **firms**, climate strategy will have to become fully integrated with business strategy. Firms will need to adapt to the changing regulatory environment and consider their climate change responsibilities in all decisions making, particularly new business investment. Not only should climate change mitigation and adaptation be integrated into strategy, it must also be central in risk management and governance processes. Over the next few years, depending on jurisdiction (2023 in New Zealand), disclosure of climate threats will become mandatory for listed and large private companies under the framework created by the Task Force on Climate-related Financial Disclosures (TCFD).

Salt is an official supporter of the TCFD and its mandatory implementation in New Zealand, encouraging New Zealand companies to identify and disclose risks associated with possible transition scenarios. We acknowledge each scenario has physical and transitional risks. However, an orderly transition will have the greatest long-term outcome and best position us to meet the net-zero 2050 target and the fast-approaching 2030 milestones. While mandatory in New Zealand from 2023, we encourage companies to get onto it sooner, as the process alone will bring key climate-related risks to the surface across different scenarios.

There is a critical role for **investors** to play in seizing the opportunity in the sustainable transformation of the planet. Innovation is occurring at an ever-faster rate, and sustainability is a key driver of that innovation. If fund managers don't seize this opportunity they will fail to support the necessary transformation of the economy and risk their own business viability. We explore the key risks and opportunities in the next section.

What does this mean for fund managers?

Climate change is real and the world in which fund managers operate is changing rapidly. This includes the regulatory environment in which we operate, businesses are changing and adapting their processes to comply with those regulations, and consumer preferences and expectations are changing.

More specifically there are 5 key reasons why fund managers must take climate change seriously:

1. The fundamental structure of the economy will change. Reducing GHGs will require a fundamental change in the energy value chain. The operational dynamics of nearly every business will change to some degree. This will lead to shifts in firm competitive advantage with the key metric of success being a firm's ability to minimise its carbon footprint. There will be losers, but there will also be winners.
2. Transition will be important. While there will be many successful new companies providing new solutions, the economy can't transition immediately. Some currently high emitters that are investing in transformational technology to reduce their resource intensity may prove to be long-term success stories.
3. Deep knowledge of industries and engagement with companies will be critical. Effective stock selection through active management will be key to managing environmental risks and identifying opportunities. This includes those companies that are finding new solutions but also those that are an important part of the transition to a lower carbon future.
4. Climate change is creating a proliferation of new risks that need to be managed in society, in firms and within portfolios. This includes the actual physical risks of climate change including extreme weather events and rising sea levels, growing regulatory and policy risks around emission standards for cars and buildings etc., and the reputational risk for companies not meeting the new standards of stakeholders and suffering customer or investor revolt.
5. Clients are increasingly demanding and expecting climate change action within their portfolios. It wasn't that long ago that the first question after nearly every client presentation was on the outlook for mortgage interest rates; now it's almost universally questioning what action we are taking in portfolios to mitigate climate change. Furthermore, we have a fiduciary obligation to act in the best interests of our clients.

Salt: A broad commitment to sustainability

Salt Funds Management is an active manager in equities, leading the way in ESG integration and alignment with client values. As a fund manager, our core objectives are to manage client funds in a way that does not do harm, to use its position as a shareholder to encourage and support companies to do better, and where possible, to do good while continuing to deliver strong returns to our clients.

The transition to a sustainable economy will be ongoing. Through active management, stewardship, innovation, and sustainable leadership, we can deliver more sustainable returns in the long term while activating positive change to support a faster transition for the benefit of generations come.

Salt is a long-standing signatory to the United Nations-sponsored Principles of Responsible Investment (PRI), which are a core part of Salt's Responsible Investment Policy. We are encouraged by the growing number of PRI signatories, directing capital to do better. Along with the PRI, other initiatives and frameworks help companies, investors, and communities streamline efforts to assess risks and opportunities appropriately and formulate strategies to mitigate and adapt to transition to not only a low carbon economy, a sustainable economy.

Salt supports the UN Sustainable Development Goals (SDGs) and believes it can positively contribute to achieving these goals, both operationally and through its investment process. The SDGs are an articulation of the world's most pressing sustainability issues and act as the globally agreed sustainability framework. The 17 goals cover all aspects of development, from affordable and clean energy to good health to eradicating poverty and hunger. While we support the achievement of all SDGs, we believe the following are where we can make the greatest contribution from our business operations:

Through sponsorship and partnerships, Salt contributes to the following SDGs:

The failure to achieve SDGs will impact all countries and sectors to some degree and create macro-financial risks. On the contrary, achieving the SDGs will be a driver of global economic growth, which we acknowledge as a structural source of financial return.

Climate Action (SDG #13) is addressing the most significant threat to planet earth and our investment universe. Salt prioritises climate change mitigation and adaptation, both operationally and in its investment process. In New Zealand, policy direction from the Climate Change Commission, legislation from the Government, externality pricing tools like the Emissions Trading Scheme, corporate leadership, investors and the New Zealand community all play pivotal roles in orchestrating the necessary change to mitigate climate change and adapt where necessary.

Salt is on a journey of creating a culture of sustainable awareness and action, doing its part to contribute to the SDGs and demonstrate leadership amongst its peers. The most significant opportunity is through integration and stewardship in the investment process. We also believe the small actions we take every day, collectively can make a worthwhile difference.

Integrating ESG factors into our Australasian portfolios

We believe that superior investment outcomes are achieved when ESG considerations are integrated into bottom-up research and included in the investment process. ESG is fully integrated into Salt's quantitative and qualitative research. Sustainability, in a range of senses, is a central criterion for the way Salt's team will view any given investment opportunity.

In addition, for internally managed funds, Salt analysts determine ESG scores for each company, which is incorporated into the factor score and stock ranking. Salt elects to do this internally to avoid potential inconsistencies from external data.

At the macro level and with specific regard to the environment and climate change, we recognise that all around the world, including Australasia, countries are taking important and meaningful steps to protect their natural resources and environment. This includes the better pricing of externalities, with New Zealand's Emissions Trading Scheme a great example. Such trends can obviously impact on the financial returns of companies operating in these areas. We build our analysis of this understanding into our proprietary models.

Similarly, environmental law is developing in various countries, including in developing economies. This will place increased obligations on corporate entities, and the risks (and opportunities) that arise require careful management.

At the firm level, environmental factors include:

- Climate change
  - For example, transitional risks and opportunities, physical risks and associated pricing of externalities.
- Pressures on natural resources
  - For example, water scarcity, biodiversity, land use and forestry and marine resources.
- Pollution and waste
  - For example, air pollution, water pollution and waste and waste management

We do not solely rely on desk-based analysis. Active engagement is a core part of Salt's research process, engaging with companies in different ways to enrich internal company research and provide stewardship at the same time. Examples include applying pressure toward best practices in one-on-one company meetings, voting, and company questionnaires.

Global equities: strong on engagement, light on carbon, built on quality

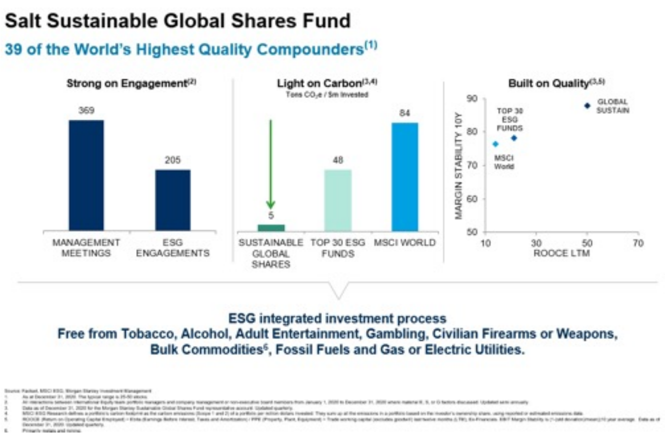
Where Salt does not have in-house expertise to manage an asset class, we appoint the underlying managers consistent with Salt's approach. Alignment with Salt's values and investment beliefs is a key part of the due diligence process when appointing an external manager.

The Salt Sustainable Global Shares Fund (sub-manager Morgan Stanley Investment Management) is a high quality, low carbon portfolio using bottom-up fundamental analysis and active engagement with company management, when appropriate, to identify material environmental, social and governance (ESG) risks and opportunities to the sustainability of long-term company returns.

The Fund's strategy is based on the belief that owning high-quality companies can achieve sustainable high returns over the long term. When selecting companies to invest in, material social and environmental risks to the sustainability of these high returns need to be anticipated, acknowledged and assessed.

The Fund will not knowingly invest in any company whose core business activity (more than 10% of a company's revenues) involves tobacco, alcohol, adult entertainment, gambling, gas and electric utilities, bulk commodities including fossil fuels, civilian firearms and weapons.

The result is a naturally carbon-light portfolio, given the avoidance of low-return polluting sectors such as Materials, Energy and Gas and Electric Utilities and has typically less than 10% of the carbon footprint of an average company in the MSCI World Index.



Active ownership is a critical part of the investment process. Management engagement is a critical underpinning to an active investment process. The MSIM team has a long history of direct engagement with management (executive and non-executive) on material risks and opportunities to long-term sustainable returns, including ESG factors.

Topics of conversations are typically diverse and include enhancements to supply chains to reduce waste, water consumption and CO2 emissions, the use of plastics, renewable energy, the use of natural ingredients, gender diversity, data security, product safety, employee and supplier safety, remuneration structures and incentive schemes, responsible marketing practices, relationships with regulators and overall company culture.

More recently, MSIM have introduced new explicit non-financial objectives to ensure the portfolio maintains its low-carbon status. While manager-led engagement on ESG issues will always be a key part of the investment process, MSIM have recently started a co-ordinated program of company visits to understand, evaluate and encourage credible decarbonisation pathways. Going forward, the Portfolio Managers will use their discretion to sell stocks that make insufficient progress on their carbon objectives.

Real Assets: managing the transition

In global property and infrastructure we sought a manager with a high degree of ESG integration into their investment process, but who also understood - and was thus able to support - the difficult transition ahead from fossil fuels to clean energy and to a more sustainable future.

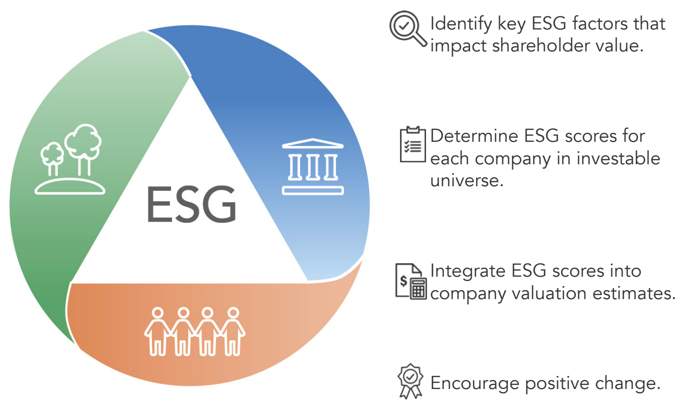
Cohen & Steers understands the global economy is being transformed by the shift to renewable energy from fossil fuels. President Biden's recent infrastructure stimulus proposal is the latest in a growing list of global initiatives supporting renewable energy. As wind and solar generation has become more economically competitive through innovation, scale efficiencies and tax incentives, most U.S. utilities have been actively building out renewable energy assets. Cohen & Steers believe these investments, along with grid modernization efforts, have the potential to drive significant growth opportunities for U.S. electric utilities and renewable energy developers.

Within their property portfolio, Cohen & Steers sees a number of compelling investment themes in the "new-economy normal". Growing reliance on digital platforms is helping drive demand for properties that provide the infrastructure for data networks and e-commerce logistics including cell towers and data centers. At the same time they recognize many companies may allow for more flexible work places post the Covid pandemic, potentially shifting demand from urban centers to the suburbs and lower-cost states.

On top of understanding the key macro drivers of energy and property transformation, Cohen & Steers believe

ESG factors can influence their evaluation of a security's expected total return. Their assessment of corporate governance is at the forefront of their fundamental analysis. In addition to providing a foundation for value creation and total return performance, they believe strong governance is critical to driving sound environmental and social practices and achieving sustainable business models. Furthermore, they believe companies that integrate ESG considerations into their strategic plans and operations can enhance long-term shareholder value while mitigating potential risks.

Environmental, Social, Governance Factors are Key to the Strategy



Cohen and Steers understand that environmental and social factors tend to vary meaningfully across sectors, demanding a customised approach to ESG integration across their strategies. Within their Infrastructure strategy, key considerations include:

- CO2 emissions, costs of associated credits
- Subsidies for green power offtake, risks to environmental policies and regulation
- Water stress, land use
- Nuclear liabilities

And within the property strategy, key considerations are:

- Green building opportunities
- Energy management
- Green bond issuance
- Waste management
- Water management
- Green leases

With Cohen & Steers, we are delighted to have been able to appoint a real asset manager with scale, a strong commitment to ESG factors and an investment strategy that supports the transition of the planet to a more sustainable future.