HEALTH WEALTH CAREER

INVESTING IN A TIME OF CLIMATE CHANGE

DISPATCH FROM COP21

WHAT THE PARIS AGREEMENT MEANS FOR INVESTORS

JANUARY 2016

MAKE TOMORROW, TODAY

MERCER

INTRODUCTION

The 21st UN Climate Change 'Conference of the Parties' (COP21), held in Paris, concluded on 12 December with a landmark agreement. For the first time, countries commit to lower their greenhouse gas emissions sufficiently to keep a global temperature rise well below 2°C this century, relative to pre-industrial levels.

Given that we have already reached 1°C of warming, this outcome raises the level of near-term 'climate transition[1]' risk for investors – based on the strength of climate change policy that is now needed. However, this is balanced by the opportunity for investment in low-carbon technologies and infrastructure, which are likely to grow significantly.

Mercer is actively involved in discussions on integrating climate considerations within investment practices. We participated in COP21 events in order to promote our thoughts on best-practice for investors in a time of climate change.

To help clients understand the relevance of the COP21 agreement, this Dispatch:

- **Summarises** key elements of the Paris Agreement
- **Sets forth** how investors can measure and manage climate risk and pursue related opportunity
- **Communicates** Mercer's commitment, including to the **Paris Pledge**

[1] Climate transition risk can be defined as a combination of climate policy and technology developments. These are two of the four climate risk factors included in Mercer's TRIP climate risk framework. The other two factors are 'R' (resource availability) and 'I' (physical impacts). Birgden, H (2015) *Climate Risk Factors Bring the Long-Term into Closer, Sharper Focus*, available at http://www.brinknews.com/climate-risk-factors-bring-the-long-term-into-closer-sharper-focus/.

THE PARIS AGREEMENT

> "The agreement not only unites all nations in the battle against climate change, it also sends a clear signal to markets about the direction of government policy, which will help spur greater private sector investment in low-carbon technology."
>
> - Michael Bloomberg

COP21 has given us the '**Paris Agreement**'. It is a bold commitment to drastically reduce carbon emissions and transition to a low carbon economy.

The approach taken at COP21 was very different from previous attempts. Firstly, rather than using the meeting to negotiate specific emissions reduction targets, countries were invited to submit their pledges in advance – over 180 countries did this, via Independently Determined National Contributions (INDCs), reflecting their own circumstances. Secondly, there was unprecedented engagement by 'non-state actors' – investors, businesses and civil society – committed to achieving a strong outcome. Their efforts have a reinforcing effect: the level of ambition reflected in the Paris Agreement sends strong policy signals which businesses and investors cannot ignore.

It was known well before Paris that the INDC pledges were—in aggregate—insufficient to limit warming to 2°C this century. Thus, the Paris Agreement sets out the overall level of ambition and a framework to facilitate monitoring of each emission reduction pledge as well as the tightening of pledges over time.

Investors should expect portfolios to be impacted by evolving investment risks and opportunities, along with growing scrutiny from beneficiaries and stakeholders in regards to how investors respond to climate change (for example, whether portfolios are aligned with a 2°C outcome).

While the deal is significant, there is hard work ahead: The difficult and complex work of decarbonizing the economy has begun and will need to intensify going forward. The risks and opportunities for investors created by this transition are potentially significant – this is an area where Mercer can help.

KEY FEATURES OF THE PARIS AGREEMENT

- **Temperature Goal** – An aim to limit overall global warming to less than 2°C , and possibly even down to 1.5°C. Given that we have already reached 1°C of warming, this will require a significant ramp up of national pledges by 2030.
- **Coming into Force** – In April 2016, once at least 55 countries accounting for 55 percent of global emissions have formally signed it.
- **Net Zero Emissions Goal** – It was agreed that we would reach "net zero" emissions in the second half of the century (by balancing carbon released with an equivalent amount sequestered or offset), with emissions peaking "as soon as possible".
- **Five Year Review Cycle** – Pledges will need to ratchet up over time, with countries re-submitting every 5 years. Submissions can only be strengthened (i.e. no backtracking on prior pledges) and long-term targets are encouraged.
- **Climate Financing** – To provide financial support to poor countries on the cost of the transition, the agreement has a climate finance goal of US $100 billion per year by 2020. This amount is a floor, so it is anticipated that it will increase over time.
- **Legal Status** – Emission reduction plans are not legally binding, but the reporting mechanisms (yet to be determined) and the 5 year review process is. There will be a strong role for non-state actors in 'policing' the Agreement.

MERCER'S CLIMATE CHANGE EXPERTISE

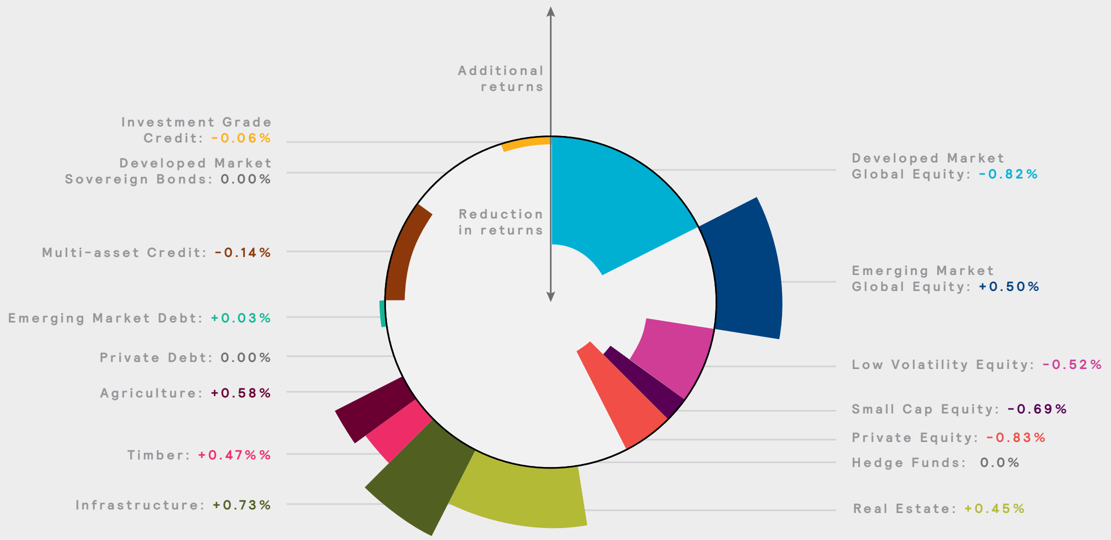
As advisors to thousands of long-term investors around the world, Mercer strives to develop straight-forward approaches to managing complex risks such as climate change.

In 2015, we published our second ground-breaking study on climate change and investment, entitled ***Investing in a Time of Climate Change***. Undertaken in collaboration with 16 investors representing US $1.5 trillion in AUM, this study established a formal framework for considering the impact of different climate change scenarios on investment risk and return across asset classes and sectors.

The study drew some important conclusions – including that climate change will have an impact on returns regardless of which scenario unfolds and that investors can take specific actions to make their investment portfolios more resilient. The Transformation scenario, which sees warming limited to 2ºC this century, is now considered more likely than it was just a few months ago. Expected investment return impacts under this scenario are shown below.

Our study also introduced the concept of **Future Maker** investors; those that make a concerted effort to influence the climate scenario which comes to pass.

Expected median annual return impacts over 10 years in a 2ºC scenario[2].



[2] See the full report for important notices on the determination of these estimated impacts. Mercer (2015) *Investing in a Time of Climate Change*, available at http://www.mercer.com/content/dam/mercer/attachments/global/investments/mercer-climate-changereport-2015.pdf.

TOOLS FOR MANAGING CLIMATE RISK

Our climate risk framework is available to fiduciaries around the world and helps investors measure the impact of each scenario on existing or prospective investment allocations – enabling stress testing of portfolios under different climate change scenarios over the coming 10-35 year time horizon.

In addition to our total portfolio climate risk tool, Mercer has invested significant resources to provide investors with a number of unique solutions:

- Board and Committee **education and investment beliefs** workshops
- Access to 3rd party security-level **carbon and ESG data** to conduct portfolio-level reviews
- Research and solutions covering sustainability-themed and low-carbon private and public market **investment strategies** across asset classes
- **Mapping** of location-specific environmental risks with Marsh Analytics to assess exposures in real asset portfolios
- **Advice** on reporting to and engaging with stakeholders

NEXT STEPS FOR INVESTORS

The Paris Agreement has underlined the importance of investors understanding their exposure to climate risk. Given the potential return impacts for portfolios, asset classes and industry sectors, there are a number of actions we recommend clients take. Governance is central to these actions but a range of practical initial steps and portfolio-level activities are also required – we set these out in the graphic on the following page.

Mercer's commitment – The Paris Pledge

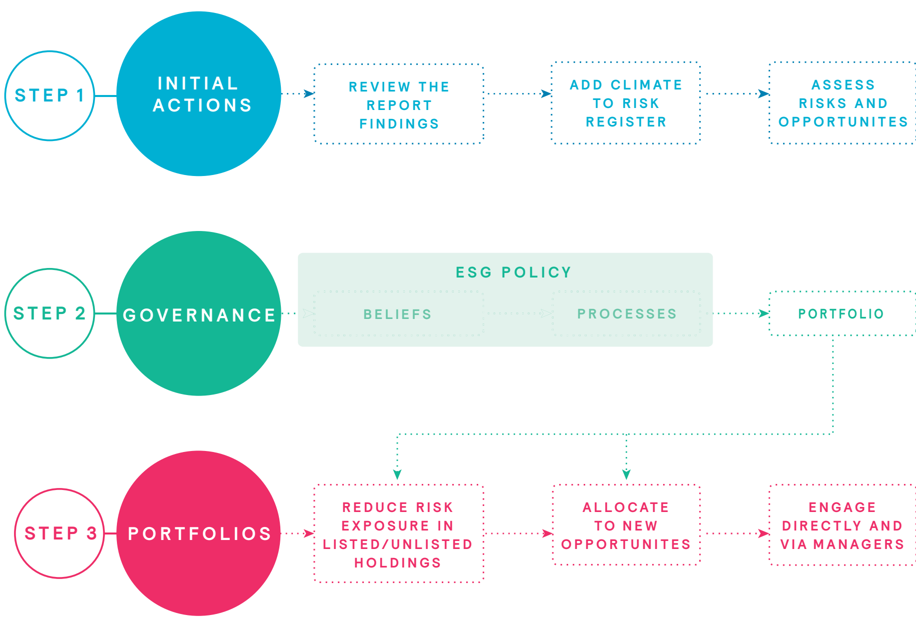
Mercer believes that climate change poses an investment risk that requires management by investors today. By signing the 2015 Paris Pledge for Action and the 2014/2015 Global Investor Statement on Climate Change, Mercer has supported two initiatives that signal the investment community's support for strong domestic and international climate policies.

HOW MERCER CAN HELP

We are experts at assessing climate risk for investors and we can help you:

- **Build awareness** through education and a portfolio climate risk assessment.
- **Improve governance process** by incorporating climate change risk within your plan framework and communicate effectively to drive decisions on a portfolio level.
- **Implement** using the twin portfolio levers of investment and engagement to prioritise portfolio risk reduction and investment opportunities.

The framework diagram below outlines the key steps Mercer can now help you take:



While the ambition of the Paris Agreement is important, it is the implementation of the commitments that will ultimately determine the climate pathway we follow – thus, ongoing monitoring is an essential requirement of any investor plan.

Contact your local Mercer consultant to put climate change on your 2016 agenda.

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