

UBS Nobel Perspectives

Exploring the economy and the environment

Are there any conclusions that you care to draw from COP26, the UN Climate summit so far?

I think a lot of the negotiations are out of the press, but it does appear that there's going to be some agreement on methane as a short-term target reduction. It also sounds like there isn't going to be much of an agreement on phasing out coal, which is one of the other targets that was widely discussed before the meeting.

As we have just seen during the COVID period, it is very difficult to mobilize a collective of governments even when the threat is grave and immediate. Should we be surprised by how little progress has been made since the Paris Agreement in 2015?

The drawback of climate negotiations for a long time was that it seemed like it was distant in the future and easy to kick the obligation to do something about it down the road, so the next generation can deal with it. We're seeing major climate disasters which are attributable to climate change that I think that should be motivating the populations of all these countries and the diplomats are sort of behind this in terms of the will of the people.

There are some commentators that believe that financial market practitioners can do nothing to influence climate change until governments and regulators hard code the rules of the road. Do you agree with this line of reasoning?

The financial sector is such a powerful agent for change, but it's designed to send capital to companies that are profitable and companies that have good prospects in the future. So if we can change the rules so that the best, most profitable companies are the ones that are dealing with climate change, then the financial sector is really a powerful engine.

If we don't have a price on carbon so that we're not penalizing companies, the big emitters benefiting that are there, solving emission problems then we have the much more complicated task of figuring out what you can do to support the change that is needed. If it's not the same direction as profit maximization, and I think that's a big challenge, I think finance is struggling with how to do that.

Investors want to invest in green assets but they don't want it to hurt their returns and so they're conflicted in the same way that the finance sector is. So I think that the finance sector can do some things. They can certainly help with adaptation to climate change, but the big capital movements to mitigate and to reduce emissions, I think the financial sector is going to be handicapped in how it can deal with that.

Your Nobel prize was awarded for your ground-breaking work on the instability of volatility regimes for security prices. How has it influenced the work you have more recently been doing on climate risk and could you give us some insights into that work?

Well volatility is everywhere and one of the things that you might expect is that companies that are exposed to climate risk are going to have more volatility and more risk and so wise investors might avoid those high risk assets and one of the things that happens is that their stock prices will not appreciate as fast as other companies, and so their stock prices are likely to be lower, everything else being held equal because the risk is higher.

But as a consequence of that lower prices it actually mean there's a positive risk premium so that investors are conflicted because they recognize that the assets that are most exposed to climate risk have a positive risk premium and so they actually look good in your portfolio even though you might not want to hold them for other reasons.

Measuring volatility is really part of it. We talk about finding hedge portfolios, which is really a good way for investors to think about what they're really trying to accomplish with climate investing and what that means is that you don't really know how bad

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the climate change is going to be, how bad the damage is going to be, but you might like to have a portfolio that does better than the market.

If the climate turns out to be worse than the market thinks it is, the upside of the other side of that is of course, is that your portfolio would underperform if the climate doesn't turn out to be as bad as the market thinks it is, but that might be ok with us because we have good a better state of nature and then we wouldn't require as much from our portfolio.

So this kind of a hedge procedure does have the benefit and explains why you might want to under invest in companies that are the brown companies and over invest in the green companies.

From a portfolio construction perspective is thinking about climate risk similar to thinking about gold?

The one difference between that is if you're going to invest in gold you know how to do that. You can actually buy the metal itself or gold mines. In the climate case, you don't know exactly how to buy this hedge portfolio as you don't know what it is and so we have to build models to figure out what it actually ought to look like.

We have a website which posts everyday measures of risk in lots of different segments of the economy and we follow something close to 200 publicly available funds which all are oriented towards climate change and so we can look at the performance of these funds and what we think the theory is that these are actually hedge portfolios.

Assets go down in value and these hedge portfolios outperform and if in fact the climate is worse than the market thinks today, there would be accumulation of outperformance that would make these funds actually outperform, but it's because the news about the climate was worse.

In addition to buying a climate portfolio as you have suggested, investors can potentially immunize their portfolios from climate risk by actively changing the carbon footprint through security selection. This is clearly the preferred way being articulated in the Net Zero Asset Manager Initiative, but can you discuss the merits of investors owning carbon credits and carbon offsets?

Carbon credits are certificates that you would buy as especially a European or a California company. You'd buy credits to permit CO2 into the air or other greenhouse gases, and the more you omit the more certificates you need.

You have to actually pay for these emissions and the price of these has gone up dramatically in Europe and more slowly in the couple markets in the US and so one of the things that you might invest in is you might buy these credits even though you're not a polluter. You're just an investor, but by owning these credits you're participating in the increased price that comes from the demand for emission certificates.

This is a little bit like gold in the sense that you kind of know what you're getting when you buy it. It's sort of a fundamental kind of portfolio. The carbon offsets also have that kind of character to them, because as far as the planet is concerned if you reduce emissions by a ton of greenhouse gases that's going to have the same impact on the future as if you have some company that pulls a ton of carbon out of the air.

It'll still leave the same amount of carbon in the air and we would expect the same kind of damages, so carbon offsets are designed to pay for a process that take carbon out of the air. So, what are these processes? Well, some of them are complicated ways of putting devices chemical devices in the smokestack of coal fire power plants and pull this stuff out into old expired minds where it's supposedly going to rest forever.

Some of them are forests that are planted newly too and the trees that grow will be taking carbon out of the air, but an awful lot of them are maybe forests that are already in existence and it's not literally clear whether they're adding to the carbon cycle station.

So carbon offsets are controversial because it's not so clear exactly what they do nevertheless they are a fundamentally important part of solving the climate crisis.

There's a limited amount of credits that are actually available out there because we don't have carbon cap and trade models all over the world, although many countries are establishing them and ultimately these might become liquid financial assets that could be invested in as part of your portfolio.

How do you anticipate a carbon tax would work? Who would bear the cost, and would it be an effective way to decarbonize?

A carbon tax is most economists favourite tool for dealing with the externalities like greenhouse gases. When you think about how you implement attacks there are a lot of political issues there. The most likely way of doing a carbon tax would be to tax companies based on the emissions that they do, plus the emissions that their customers will do if the customers are not corporations themselves.

So, it would be households who buy the product and for example a refinery would be taxed for its own emissions, but it would also be taxed for the emissions that the gasoline companies sell to customers.

These customers or households like us burn this gasoline, we're not going to have the customers to pay a special tax for this. The companies will pay that tax nevertheless the companies say, you know you're taxing this and we're going to have to raise prices so the price of gasoline is going to go up and so customers are ultimately going to end up paying the tax.

The 2020 Pandemic period really shocked demand for fossil fuels, in a way simulating the effects of a decarbonization policy. Are there any enduring lessons and how can investors balance a desire to decarbonize with the alpha opportunities in the fossil fuel sensitive sectors that are now arising after years of underinvestment?

The effect of the pandemic really looked like an extreme type of decarbonization. We stopped commuting to work every day. We stopped flying to business meetings. We had Amazon deliver our groceries. It turns out technology developed a lot of tools that were useful to help this.

I don't think business travel is ever going to recover and we're not going to expect every employee to commute every day the way we used to.

So we expect that is going to save some fossil fuels. Energy prices have gone up and energy profits have gone up dramatically this year.

There have been years of underinvestment in this sector but as the economy recovers, of course the demand for energy goes up a lot, and so one of the things we're seeing is just the recovery from the pandemic has led to a need for more energy.

But could a carbon tax work? We are seeing increased subsidies for renewable energy and some of that renewable energy is produced by the big oil companies, so in a sense, the profitability of fossil fuel companies is going up.

Thinking about ESG more broadly, what do you think about the data problem? Data is patchy and there seems to be low correlation in the outputs from the data providers – should investors care and how should investors use this flawed data? Can investors credibly engage with companies on ESG topics without robust data?

The data is very patchy and it's produced voluntarily, and particular companies are not reporting. You know this is not a good recipe for choosing a portfolio.

It is going to be a very complicated modelling task to figure out which are actually the green companies you want that would do well in a bad climate environment, and which are the brown companies that are going to do badly in a bad climate environment. It is better to have better data.

Do you think ESG slows or accelerates the disintermediation of active management by indexing and more systematic approaches to investing?

There are certainly lots of indices that are being proposed which are based on ESG data. I don't think it's very effective that they may not be nearly as green as you think partly because of all this complexity of who is actually going to pay the taxes when you look at emissions data.

Some of these big emitters would actually not be the ones that are paying the tax. It would be either their supply chains or their customers that would end up paying the tax so. I just think the index approach is not so attractive and is really a measure of what these companies are doing today, whereas what you would really like to know is what are these companies going to be doing tomorrow or in a decade.

That's going to require analysts and where active management should be able to deal with and this should include active management and passively managed funds.

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