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Accelerating Climate Resilience

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As climate risks increasingly impact global economic activity, corporate approaches to reshape business models will determine how society can stay resilient. Climate models predict that rampant Greenhouse gas (GHG) emissions will cause global mean temperatures to rise beyond previously predicted levels. Rising temperature amplifies already prevalent climate change-related risks, including heavy and erratic precipitation patterns, increased probability of droughts, sea level rise, ecosystem disruption, and mass migration, among other impacts. In fact, the World Economic Forum's 2020 Global Risk Report identifies extreme weather and climate inaction as top risks in terms of likelihood and impact.[1] These changes to the global climate present severe risks to human health, livelihoods, resource supply, security, and economic growth.[2] Companies that monitor these risks, integrate climate risks and scenarios into their strategic planning and investments, and have resilient characteristics are better able to adapt to climate change.

Research and data substantiate our views. Park & Monk (2019) find that carbon efficiency, as a proxy for GHG emission intensity, has a positive link with financial performance, especially since 2010.[3] Hunt, Chelsie and Weber (2018) find that firms that shift their assets from carbon intensive investments to non-carbon counterparts obtain higher profitability.[4] In fact, incorporating the true cost of carbon risk into returns, low-carbon portfolios can outperform their peers.[5] Companies, however, operate in complex environments, and identifying adaptive and resilient behavior within complex systems is a hurdle for investors.[6] Given our role as investors, we focus our analysis on individuals and management teams: corporate decision-making, strategic policies, and metrics.

MONITORING RISKS

Management and boards need to identify climate risks and its impacts on a corporation using a data-driven process. We believe that not doing so raises serious questions of how the company is being governed. **Microsoft** and **Adobe**, for example, are two companies that have accepted the need to identify climate risks to the company and build accountability to how these risks are managed. Microsoft has incorporated self-imposed carbon fees to estimate and incorporate the cost

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of climate risks into its business model, and estimates its scope 1, 2, and 3 emissions. It has also kicked off a company-wide initiative to be carbon negative by 2030 and remove all carbon the company has ever emitted directly or indirectly by 2050.

Adobe, for instance, reports on its climate initiatives and assessed climate risks and reports to the CDP to receive a grade on climate change programs. The company has designated multiple levels of accountability for climate risk, including three C-suite executives and the CFO, and a sustainability committee which all meet regularly to discuss and work on climate risk and opportunity. These actions demonstrate that management and board consider climate risks and accountability. We believe that they also add to the company's long-term value.

HAVE OPTIONS AND DESIGN TO DELIVER

Boards and management that value creative solutions and companies known for good execution are better prepared to manage climate risks. Experimentation, innovation, and ability to execute allow a company to create options for income streams. **Nestlé**, for example, has been working to innovate, experiment and bring products to market that address consumer concerns and preferences for single-use plastic waste reduction. This program devoted entirely to reducing packaging waste shows action being taken to change production structures and adapt to climate risks. An anaerobic biomass energy generation plant in England reuses Nestlé food waste, reducing deforestation and pollution. By thinking creatively and using resources already at their disposal, this plant has addressed climate risk and resource scarcity, making meaningful changes to adapt. Nestle also has a history of operational execution, and we believe the company has innovated to stay competitive even as conscious consumerism rises and agricultural systems face risks from climate change.

Similarly, **Schneider Electric** has a strong R&D core competency and is innovating and creating options for the energy transition. The firm acknowledges carbon neutrality as a significantly material factor and has developed a product portfolio catering to green technology, energy efficiency, batteries, and electric vehicle chargers. Given their exposures to sensors, datacenters and Internet-of-Things, the firm is also increasingly moving to software to further enhance efficiency in energy and resource usage. Schneider's management has shown operational competence to keep the company focused on growth areas relevant for a sustainable planet.

RESILIENCE

Planning for disruption, building in systemic redundancy, contingency planning in logistics and communications systems, swift response in case of crisis, and organization flexibility are characteristics that can help a company stay climate resilient. Climate risks are widespread but will likely have concentrated impacts, meaning that climate risks will impact companies' production systems in seemingly random ways. Consider how the isolated events of the Novel Coronavirus are disrupting supply chains in East Asia. If a crisis were to strike one part of a company, could the company rely on another portion of the business to fund operations? Management and boards that recognize possible threats to production and normal business function, and act to protect or shift production, demonstrate resilience, adaptability and a commitment to their company's future success. **Williams Sonoma**, for example, saw massive e-commerce related challenges to its business model of physical stores and high-end product line. Management faced up to the challenge, shifted more than half of company sales online, and expanded their product offering to appeal to a wider audience, all while maintaining a core competency of design and product development.

Some companies may have unique resilience characteristics. For example, customer retention ecosystems like those built by tech companies through networks that pull customers in and keep them loyal can help sustain revenues in the face of disruption. Having a fluid hierarchy which allows for dynamism and adaptive decision-making improves resilience by making management more agile. Rather than one missing person forcing an entire hierarchy to change, fluid hierarchies

have the connectivity and shared knowledge to adapt to new paradigms.

To some extent, the adoption of resilience strategies requires companies and their investors to challenge widely accepted measures of financial performance. Introducing systemic redundancy and maintaining "rainy day" cash cushions can result in a deterioration of short-term financial metrics such as ROE and ROI. This means that investors must be willing to price risk properly and reward resilient companies for their ability to recover and rebuild faster after a climate-related shock. Many technology companies, like **Microsoft** and **Apple**, possess significant return-mitigating cash buffers, but have not been punished for "excess equity" because investors believe in the adaptability of their business models. Investors may need to consider such evaluation frameworks for companies in other sectors.

At Promethos, we understand that assessing a company's resilience and adaptive capacity is a matter of judgement. Precise rubrics and data tell one part of the story but assessing company culture and how management fuels constant awareness, innovation, and action are less easily measured. Culture can be difficult to quantify, so as investors we look for indications of culture in a corporation's actions. By looking at what we can measure or quantify such as steps taken to prepare for climate risks, we can gain insight into managements' attitudes towards climate resilience, and identify companies which are able to adapt to and be resilient in the face of shocks and widespread climate change risks.

ABOUT US

Boston-based institutional investment boutique providing intentional global equity management

Expertise delivering a unique brand of thinking to values-based (ESG/SRI) and faith-based investing

Active investment process integrates risk management with fundamental research and ESG analysis to generate alpha potential

Employee-owned and majority women-owned firm

INVESTING WITH INTENT *because* **CAPITAL DRIVES CHANGE™**

WHAT MAKES US DIFFERENT

IMPACT: Our portfolios seek alpha and integrate intent to drive social and environmental change.

TEAM: Our CIO's extensive portfolio management experience and scientific background provides a distinct perspective coupled with a team diverse in both thought and culture.

INDEPENDENCE: We are an employee-owned firm. Our interests are aligned with your interests.

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