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Why ESG Matters (Third of a Series)

THE LEAD | April 13, 2022

Besides historic influences, climate change, diversity, equity and inclusion, and corporate accountability are now the lenses through which investors are assessing managers' ability to understand the associated risks and opportunities for every investment decision.

Despite the politics of climate change, the burden of scientific evidence and "rapid degradation of biodiversity and rise in extreme weather events" (as one report notes) have compelled global policy makers to largely unite their efforts around decarbonization.

One of the most significant is the Net Zero Asset Managers initiative. It comprises 236 signatories representing $57.5 trillion in AUM who are also aligned with the 2015 Paris Accords. Across countries, municipal, state and regional governments and major companies, net zero targets now represent at least 68% of global GDP purchasing power parity (PPP) and 61% of global greenhouse gas (GHG) emissions.

Achieving these goals will require a galactic shift in how nations employ energy resources. From a world where more than 50% of consumption is either coal or oil (see our Chart of the Week) to one powered by wind, water, solar, and other renewables, will require careful planning for the consequences.

This transition is complicated by increased capital costs weighing on less-favored fuels. By one estimate over half the fossil fuel reserves would be "stranded," with values and returns impeded by their drag in a net zero world.

Risks for fossil fuels and other industries also stem from technological innovation. If EVs follow typical adoption rates, which companies and industries will become obsolete? Won't greater battery demand mean a dramatic step-up in mining lithium, cobalt, and nickel?

Arguments against abrupt and wholesale abandonment of coal, oil and gas include unintended consequences resulting from distressed sales to bad environmental actors. Some national oil companies (NOCs) are controlled by countries less aligned with interests of their international counterparts (IOCs). Global energy supply and price dislocations remain major concerns, thrown into stark relief by the Russia/Ukraine war.

Fundamental differences exist between developed and developing worlds. Despite their reputation today, fossil fuels were responsible for huge advances in health and longevity in our history. Developing countries seek the same benefits from energy scale and access, yet they rely on coal.

The potential for social, economic and environmental trade-offs apply to US constituents as well. Similarly decades of US reliance on Big Oil won't end without significant disruption to livelihoods and communities. How that is managed politically and economically with current stakeholders is critical to gaining broad acceptance for a move to alternatives.

Still, awareness is growing, through the impact on insurance companies of weather extremes such as frequent storms and flooding, or on agriculture from heat and droughts, that climate change isn't just a theory. It's happening.

The huge investments needed to combat that change are daunting. But behavior modifications may be the greater challenge.

Next week: We continue our look at current ESG themes, with diversity and inclusion.