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ESG Perspectives

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The Paris Climate Agreement

What is it?

The Paris Climate Agreement is a cooperative effort by countries involved in the United Nations to try to limit or reverse the effects of man-made climate change over the next decade. The agreement was first crafted during the 21st Conference of the Parties of the United Nations Framework Convention on Climate Change in Paris in December 2015. As of May, 195 nations have signed the treaty, and 148 have ratified it.

The idea of the agreement is to limit the effects of humanity on global carbon emissions and to limit the increase in global temperature increases. Every country must agree to a "Nationally Determined Contribution" which provides a target range for carbon emissions reductions over a specific period. For example, the United States agreed, to reduce emissions by 26% to 28% from 2005 levels by 2025. The United States also agreed to contribute $3bn to the Green Climate Fund.

This agreement is not legally binding, rather it is a "hybrid of legally binding and non-binding provisions." Further, the penalties for not compliance have not been agreed upon, and the method of measurement of compliance is unclear.

What recently happened?

Leading up to President Trump's decision on whether or not to withdraw from the Paris Agreement, there was a growing chorus from the leaders of some of the largest and most high-profile U.S. and European based companies in favor of remaining in the Accord. The list of companies spanned the range of corporate sectors including tech, finance, and automotive. Interestingly, some of the largest energy companies, including Exxon Mobil, Chevron, Royal Dutch Shell, BP and even coal producers like Cloud Peak Energy and Peabody Energy argued that the U.S. should remain a part to the accord since it offers a framework for tackling global warming and gives the US a role in steering the global response to climate change.

On June 1, 2017, President Trump announced that the US would be leaving the Paris Accord, but would be leaving the door open to either renegotiate a better arrangement with the member countries. In response, France, Germany, and Italy released a joint statement firmly stating that the agreement cannot be renegotiated. Assuming no renegotiation takes place, the US has until November 2019, the date when the US can technically pull out of the agreement, to develop an alternative solution to address climate issues. In light of the US's withdrawal, Michael Bloomberg's foundation has offered to make up the $15 million in funding that the UN stands to lose from the US's decision to pull out, and 30 states and numerous companies are vowing to press ahead with their climate policies regardless of the federal government's stance.

Why does it matter?

Climate policy at the federal level is one of the main factors influencing the private sector, but not the only important factor. In recent years, the US corporate community in aggregate has been moving to less carbon-intense business operations driven by the following main factors: shareholder and customer demand, US potential regulation and International Climate Policy. US corporates still face rising shareholder/customer engagement on climate issues as well as climate change policy at the state/local level and international markets in which the company operates.

From the standpoint of a large corporation and those in the administration that supported remaining in the Paris Accord – without US leadership on the macro-level climate policy, US corporations and organizations now must appeal to a fragmented set of countries led by the EU and China as well as policies at the state/local level rather than the US federal government. This results in higher uncertainty about longer-term climate policy and while it could lower implementation costs to corporates (assuming less regulation in the US), it could affect longer-term business investment which has been missing from GDP data during the most recent economic recovery. As the Paris Accord withdrawal process will take several years, so will its effect on the corporate sector.

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King County Wastewater Treatment Controversy

West Point Treatment Plant is part of the King County Wastewater Treatment Division. King County Wastewater issues municipal debt to help fund maintenance, construction, and operations of their wastewater treatment facilities. Currently they have approximately $3.5 billion in combined sewer revenue debt and general obligation debt.

On February 9th, flooding at the West Point Treatment Plant, the largest in Washington State and situated on the shores of the Puget Sound, caused an instantaneous fault in the electrical systems in the effluent pumping station. Per engineering firm CH2M, which was hired to do an independent forensic analysis and piece together sequence of events, the instantaneous fault "caused one of the power feeds to shut down, which led to all the pumps shutting down. These pumps help move treated wastewater – or effluent – out of the treatment plant and into Puget Sound. Plant operators were trying to contain flows inside the plant to allow time to restart the pump station and avoid a storm water-sewage bypass. Operators were relying on an automated system that triggers the shutdown of the raw sewage pumps and opens the emergency bypass gates, but float switches that act as water level sensors failed. Forensic analysis determined the switches failed due to bent rods that occurred during many cycles of routine maintenance. If the float switches worked properly, the flooding of the wastewater plant would not have occurred. With the combination of power failure and rapid flooding, the plant was manually put into bypass mode, sending 180 million gallons of untreated storm water mixed with small amounts of sewage into Puget Sound through an emergency outfall."

From an ESG perspective, this should qualify as a major controversy event and the credit/issuer should be put under immediate evaluation for removal the ESG investable universe. Accidents happen, and how the issuer responds to this controversy will determine the course of action from an ESG investment standpoint going forward. If the issuer (King County Sewer), takes ownership of the accident, works tirelessly to restore the damaged environment at a minimum to its original health, sets up and adheres to policies designed to stop this from happening again, and is proactive in reevaluating its wastewater treatment process to consider a more sustainable and environmentally friendly process, then in the future they will be reevaluated for inclusion again within the ESG investable universe. As of March, the county has hired a firm to conduct an independent review of the incident and the county's response and to offer recommendations of steps to do going forward.

US Equity Market Sectors Through an ESG Lens

Figure 1: Sector Returns

	YTD Return
S&P 500	**7.73%**
Tech	19.67%
Cons. Discretionary	11.72%
Health Care	10.12%
Utilities	10.07%
Cons. Staples	9.36%
Industrials	7.04%
Materials	6.43%
Real Estate	3.16%
Financials	-0.33%
Telecom	-10.11%
Energy	-13.58%

Period ending 5/31/2017
Source: Bloomberg

Is there a sectoral bias to ESG investing? With the out performance of ESG strategies in the US thus far this year and the wide dispersion in sector returns (Figure 1), we explore sectoral biases of S&P 500 companies with strong and weak ESG profiles.

In this review, we compiled ESG ratings of S&P 500 companies from Sustainalytics and partitioned the index into tier 1, 2 and 3 companies. Tier one companies rank in the top third of their respective industry/peer universe, Tier 3 rank in the bottom third, and Tier 2 lies in between.

We then took the sector weighting of each tier and compared them to S&P weightings to see the sector biases of this type of filter (Figure 2). The relative weights highlight the sector tilts of companies vs. the S&P 500 – there are clear sector tilts corresponding with ESG tiers. Tier 1 companies have the largest overweight in Tech – the best performing sector - and largest underweight in Financials and Energy, some of the worst performing sectors this year. Tier 3 companies have almost the opposite profiles – underweight technology and consumer discretionary while overweight financials, energy, and industrials.

These results highlight the key role of portfolio construction in an equity ESG portfolio. Being mindful of sector tilts and using sector constraints (as well as regions for a global portfolio) are key factors to consider in achieving competitive performance results and a risk-controlled, balanced ESG portfolio.

Figure 2: Sector Weightings of ESG Tiers

	Number of Companies	Tech	Cons. Discretionary	Health Care	Utilities	Cons. Staples	Industrials	Materials	Real Estate	Financials	Telecom	Energy
Tier 1	145	22.1%	17.2%	12.4%	4.1%	6.9%	12.4%	4.1%	6.9%	9.0%	0.0%	4.8%
Tier 2	208	11.1%	18.8%	12.0%	7.2%	7.7%	11.5%	5.3%	7.2%	11.1%	1.4%	6.7%
Tier 3	143	8.4%	14.0%	11.2%	4.9%	7.7%	16.1%	5.6%	3.5%	18.9%	0.7%	9.1%
S&P 500	496	**13.5%**	**16.9%**	**11.9%**	**5.6%**	**7.5%**	**13.1%**	**5.0%**	**6.0%**	**12.7%**	**0.8%**	**6.9%**

Relative Weights vs. S&P 500

	Tech	Cons. Discretionary	Health Care	Utilities	Cons. Staples	Industrials	Materials	Real Estate	Financials	Telecom	Energy
Tier 1	8.6%	0.3%	0.5%	-1.5%	-0.6%	-0.7%	-0.9%	0.8%	-3.7%	-0.8%	-2.0%
Tier 2	-2.5%	1.8%	0.1%	1.6%	0.2%	-1.6%	0.2%	1.2%	-1.6%	0.6%	-0.1%
Tier 3	-5.1%	-2.9%	-0.7%	-0.8%	0.2%	3.0%	0.6%	-2.6%	6.2%	-0.1%	2.2%

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