InvestmentUpdate

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COP26: a good COP or a bad COP?

A just barely good enough COP (for now)

COP26 extended beyond its intended Friday finish and well into Saturday with a deal agreed, but not without late drama. After being subject to a desperately last-minute change by India and China, important new wording in the Glasgow Climate Pact was changed to a "phase down" of coal and subsidies for fossil fuel development rather than a "phase out". And so COP26 closed as many before it - with a last-minute compromise undermining the strength of the final accord.

That said, there is much good to celebrate in the midst of a messy political compromise. Article 6, the rule book for carbon markets, was finally finished and adopted, a vital step in enabling climate action in the next decade. Given how a more stringent deal seeing all nations commit to going further faster was never politically feasible, it is significant that the final wording of the Glasgow Climate Pact states the necessity that all Parties "revisit and strengthen" their commitments. And so the path for higher ambition remains open.

Was it a success? Well it depends on what you think is possible. If we lived in an ideal world we'd walk away with firm commitments for every country to make absolute emissions reductions every year from now until 2030 that would guarantee keeping global warming within 1.5ºC.

But we know from the pain of the last 20 years that that's just not possible - the transition from fossil fuels to clean energy is so all-encompassing, involving so many trade-offs and winners and losers. Human nature being what it is, it's politically impossible to deliver that kind of united, global commitment.

Even if this set of political leaders did agree to it, there's no guarantee that those leaders would survive politically to execute the plan - remember it's only a year since the US was out of the Paris Agreement entirely; so if your notion of success is grounded in what would be perfect, you'll always be disappointed.

But if you accept this reality – the signs of success you look for are accelerating ambitions and – crucially for us as investors looking after our clients' wealth – stronger market signals. And on balance COP26 has delivered those. It shows that the compromise from COP21 in Paris – bringing together everyone's individual voluntary commitments under regular scrutiny and creating a race-to-the-top mentality – *can* work.

We see a parallel with the establishment of the Bretton Woods institutions in the closing phase of the Second World War. Looking ahead to peacetime, world leaders set up the International Monetary Fund, what became the World Bank, and a system of currency convertibility designed to encourage global cooperation and financial stability. Too little far too late, many argued. But what followed was over 25-years of unprecedented calm. Paris may prove just as significant.

If you were leaving the COP21 conference centre in 2015 you would probably be astounded by what came out this last fortnight. Sadly, making the bare minimum of progress isn't justification for resting on one's laurels, nor is it yet sufficient to address the climate crisis.

Before the event, our latest *Planet Paper: Good COP, bad COP* set out three criteria for judging whether COP26 would go down as good or bad: –the 'three Cs' of commitments, co-operation and cash. How did COP26 deliver on these?

Commitments

The biggest story of week one was India's net zero commitment. Coupled with China's pledge, that took the total amount of global emissions covered by some form of net zero commitment to 90%. Yes, there are lots of caveats, and ambition is less than half the battle. But once again – looking back from 2015, the idea of 90% of emissions being covered by any sort of plan would have been far-fetched.

Towards the end of week two, the US and China announced an unexpected agreement to cooperate on cutting greenhouse emissions. A joint working group was also set up to "meet regularly to address the climate crisis" over the next 10 years. Though this was an unexpected positive development, it was not surprising that the agreement lacked any concrete commitments.

Probably most importantly, the final decision text of the Glasgow Climate Pact urged countries to "revisit and strengthen the 2030 targets in their nationally determined contributions as necessary to align with the Paris Agreement temperature goal by the end of 2022, taking into account different national circumstances". As noted above, these keep the door open to more ambitious action. Important, though insufficient references to "loss and damage" payments also made an appearance for the first time.

Cooperation

Things are much trickier to judge here. The UK's COP Presidency created a 'two COP' affair. One was the actual COP in

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Look forward

which jet-lagged, sleep-deprived negotiators debated the nitty gritty of bracketed text covering how often countries should update their emissions reductions plans, who's paying and the rules on climate finance. The 'second COP' took place in another world of press releases, photo ops, thematic focus days and higher ambition pledges covering specific areas. In case you missed them, here are the highlights:

Coal
More than 40 countries, including Canada, Poland, South Korea, Indonesia and Vietnam have committed to shift away from using coal-fired power.

Methane
More than 100 countries have signed up to a global initiative that aims, by 2030, to slash methane emissions by 30% compared to 2020 levels.

Deforestation
More than 100 countries promised to reverse deforestation by 2030 in the first major deal agreed at COP26.

- Roughly 85% of the world's forests are covered by the pledge, with the countries signing up including Canada, Brazil, Russia, China, Indonesia, the Democratic Republic of the Congo, the US and the UK. More than 30 global investors, including Aviva, Schroders and AXA, have also promised to end investment in activities linked to deforestation.

Financing
Twenty major economies, including the US, Canada, the UK and Denmark, committed to end public financing of fossil fuel projects abroad by the end of next year.

- UN Special Envoy Mark Carney provided an update on the financial institutions signed up to the Glasgow Financial Alliance for Net Zero, which now numbers 450 firms, or roughly 40% of the world's financial assets under management. This growing commitment is likely to amplify a trend we're already seeing – all else being equal, companies that display good corporate social responsibility on matters material to their business model are benefitting from relatively lower costs of capital.

What's the effect of all this, plus the net zero pledges? Well, that's debateable. If you are the International Energy Agency (IEA), applying an optimistic lens to ambitions and seeing them more as commitments, you'll see a world that can keep global warming to 1.9 degrees. If you are Climate Action Tracker, you see 2.4 degrees guaranteed, with devastating impacts on humanity.

Fundamentally, even if interpreted optimistically, this would be the first time that any collation of agreements would get anywhere near to the Paris agreement goal of limiting global warming to well below 2 degrees. The caveats to that statement would require double the word count; but as Sir David Attenborough 'encouraged' the conference on day one, we must live on with a "desperate hope".

Cash
We wrote ahead of COP26 of the vital need for developed countries to deliver on promises to invest in climate finance in developing countries. Specifically, to step up on attaining a pledge by developed nations to send $100 billion a year to the developing world by 2020, which had been missed by some margin.

The climate financing is important as it signals a sense of shared but differentiated responsibility, while also sending some potentially powerful market signals. However, things fell short, before the COP even started, as the developed countries announced a plan that would push the $100 billion a year figure forward to 2023 at the earliest. Even that promise lacked the specifics we called for in our *Good COP, bad COP* paper. There remains some small hope that the figure will be exceeded in the latter half of the decade.

An important question for investors, and one for which there is a lot of diverging opinion out there, is whether the transition to Net Zero will help or hurt economic growth. A recent IEA report concluded that annual investment in the energy industry will need to rise from $2 trillion per year today to $5 trillion by 2030 if we are to transition to a net zero world. But you can't simply add that extra $3 trillion per year to annual GDP and say 'happy days, more growth'. Capital doesn't grow on trees, and this additional investment in clean energy is most likely to come from capital that otherwise would've been invested elsewhere.

So will the net zero transition lead to less innovation, less productivity growth than if this capital wasn't diverted from elsewhere? We don't think it will for a couple of reasons. First, some of this investment is likely to be in public infrastructure, which economists generally view as encouraging lots of job creation, "crowding in" additional investment and raising productivity. The second reason we are hopeful is that the fall in the cost of clean energy technology to date has been absolutely phenomenal, exceeding pretty much all optimists' expectations from 10 to 20 years ago. If you assume an exponential fall in the cost of clean energy continues – as the cost of many other technologies has over the last 50 years – you might find that the transition actually boosts growth. After all, most of the five great waves of productivity growth since the late 18th century have been driven by energy revolutions.

But policymakers need to take action now to keep the economic costs from outweighing the benefits over time. Economies and businesses can evolve and adapt to well-signalled and spread-out changes, but a more sudden imposition of policy – for example in 2028 or 2029 – could entail huge transition risks. And it isn't just about

policymakers. In our engagement with higher carbon businesses, we urge them to adopt robust decarbonisation policies today, to decrease that risk of a more sudden, financially disruptive policy being imposed by governments further down the line.

A (just barely) good (enough for now) COP

Taken in aggregate, balancing the possibilities and retaining the right to check on progress, we consider COP26 to have been just barely good enough for now.

When it finally came to a conclusion, a visibly emotional COP president Alok Sharma spoke for many, expressing sincere regret over the necessity to bow to last minute demands in order to save all the work contained in the rest of the agreement. "I think we can say with credibility that we have kept 1.5ºC within reach" he concluded, "but its pulse is weak."

Though the watering down of the wording on coal was disappointing, it was still the first ever reference to a specific fossil fuel in a COP text. This further signals the realities of the low-carbon transition and its relevance for financial markets. The statements on coal and methane alone will breathe new life into hard discussions with many high emitting companies and give fresh impetus to every dialogue we have with them.

Taken in aggregate, the statements and commitments coming out of the COP process can serve as a powerful market signal. And they matter for the investment world's engagement work on climate change.

We understand that this has important consequences for the health of the global economic system, the environment and society. Risks from climate change can also have a material impact on investment returns, and by integrating the analysis of ESG factors across our entire investment process we can achieve a balance between these aims.

We recognise not only that our business and those businesses in which we invest are impacted by climate change, but also that the choices we make as stewards and allocators of our clients' wealth have the potential to either exacerbate, or alleviate, the climate crisis. Rathbones is also among a number of wealth managers that have announced specific net zero commitments, which take into consideration the role our investment decisions play in the transition to a net zero economy.

Whatever governments do or don't do, there will be investment opportunities in well-run companies helping the world on the road to net zero, or helping the world cope with the physical effects of climate change already with us.

Company engagement has been an important part of our stewardship activities for many years, with direct engagement with companies growing from 31 in 2018 to 226 in 2020. We will continue to use our voice, on behalf of our clients, to be an influence towards better, more sustainable long-term performance.

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