# SUSTAINABLE INSIGHTS 2014 PREDICTIONS

## *Mid-Year Review*

Sustainable Insight
CAPITAL MANAGEMENT

JULY 2014

*In January 2014 we made **ten predictions** about the current year . Now that we have just passed the half-year mark it appears a good time to review how we are doing; were we on target or just optimistic? We reveal our successes and disclose our shortcomings below.*

1. **China and environmental policy.** We predicted that China would set the pace on environmental policy with more financial penalties for polluters and new carbon trading schemes. This has proved correct. Pollution has become a potent political problem encouraging policymakers to instigate environmental change. Witness the launch of China's first carbon linked product. The country has banned high-sulfur and high-ash coal imports. Carbon emission reporting requirements are now in place and the Ministry of Environmental Protection has been targeting recalcitrant corporates (Insights Edition 23, 28, 32 & 34). We would not have predicted that a state-owned insurer would offer Beijing residents health coverage related to air pollution nor that companies would be paying employees pollution compensation. Some could argue that the US has now seized back the spotlight, following the Obama Administration's power plant carbon emission plan, but China has built up an environmental impetus.

2. **Financial markets will become increasingly nervous about stranded costs.** We believe we are on the money with this prediction as well. Not only have activist shareholders forced responses from Big Oil (Insights Edition 29, 34, 36 & 38) and Big Coal about the possibility of stranded carbon assets, but a divestment campaign at universities is ongoing, although with only pockets of success. Some major institutions have joined the fray (Insights Edition 24, 27, 29 & 32). The Obama Administration's and EPA's plan to cut carbon emissions has further highlighted the financial risks of regulatory changes. The banks have not escaped the attention of the anti-coal lobby causing major financial institutions withdrawing funding for such projects, notably in Australia.

3. **Further progress on sustainable accounting standards.** Again, this prediction is running to plan. If anything it may have accelerated more than we anticipated. The Sustainable Accounting Standards Board (SASB), with its strengthened leadership team, is releasing further standards on schedule – most recently one covering non-renewable resources (Insights Edition 31 & 49) – as are other organizations. Stock Exchanges continue to sign-up to the UN-backed Sustainable Stock Exchanges Initiative, which promotes sustainable practices among listed companies. The European Parliament has passed a law requiring ESG disclosure. The recent UK Law Commission report concludes that trustees should take into account factors that affect financials but it is also critical of ill-defined ESG issues. Many institutions are continuing to encourage further reporting of ESG factors (Insights Edition 24, 29, 30, 33 & 35) as it is incorporated into more investment processes. The only outstanding question is whether this pace can be maintained in the second half of the year? Unlikely we believe.

4. **The Earth's oceans will receive significantly more publicity.** Following three-in-a-row of correct predictions, we can only claim to be half right on this, at best. We could cheekily claim to be right if we included the ongoing territorial disputes in the South China Sea, but that would be really pushing our luck. Elsewhere you have to go searching for coverage about the state of our oceans. While the mainstream media did pick-up the story that President Obama may significantly expand the world's largest ocean reserve, which would be larger than Alaska, the 'month of the ocean' (June) was barely acknowledged. There was media coverage of the IPCC's comments on the oceans (Chapter 5), focused on rising sea levels and temperatures, but EU edicts on overfishing received little exposure as did the World Ocean Summit back in February. We are still sticking with our prediction that more will emerge in the press in the second half of the year, but we do not have the same confidence level as in January. Let's hope it's not a disaster that provides the stimulus.

5. **Genetically modified organisms (GMO's) will remain hotly debated.** We believe we are on the right track. The GMO labelling movement continues to gain support, with bills in 29 state legislatures. Meanwhile Big Ag continues to innovate not only on seeds, but on farm systems approaches. We were right on Palm Oil producers adopting the Roundtable on Sustainable Palm Oil certification program, now standing at 16% of total world production. And we were right on the world's chocolate supply being in deficit this year, causing "death by chocolate" to short traders of the softs. We expect further supply tightening in the next six months.

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6 **Little progress on climate change policy.** On balance this could go either way. Suggesting that we could have been unduly pessimistic with our prediction is the recent announcement from the Obama Administration and the EPA on limiting carbon emissions; real progress looks possible. Furthermore, this was followed by a Supreme Court ruling upholding the EPA's rights to limit most greenhouse gas emissions. However, supporting our cautionary expectation is Australian Government policy, a former climate change front-runner, and the UK, which looks to be back-pedalling. Meanwhile Germany has decided to reduce renewable subsidies and Spain to set a cap on them while Japan is struggling with nuclear restart costs, suggesting rising fossil fuel consumption. The UN Climate Change Summits in the second half of 2014 (New York and Lima) will probably settle the score on our prediction.

7 **IPCC achieves more exposure for its reports.** We anticipated that the IPCC would receive more positive media attention than in the past. We believe we have been correct with one possible caveat. Certainly the Fifth Assessment Report (AR5) updated many media commentators on the current state of scientific knowledge. Post the Working Groups' press conferences, global media was awash with the findings, notably the recommendation that the world move away from carbon-intensive fuels. Despite widespread consensus among so many scientists, some negative coverage emerged when there was a disagreement between some of the authors (Insights Edition 35 & 38). However, we argue that the 'negative' publicity over economic costs and responsibilities sparked a debate, which continues, over the financial modelling of climate impact scenarios (Insights Edition 43, 47 & 48).

8 **Oil majors increase their renewables expenditure.** We suggested that Big Oil might surprise investors with a rejuvenated renewables investment plan. To date, this has proved wrong. Instead Big Oil has been tackling activists on the issue of stranded costs (Insights Edition 34, 36 & 38). Certainly there are many commentators forecasting a renewable investment boom (Insights Edition 25, 37 & 49). Also other corporates are boosting environmental spend. But Big Oil is not partaking. There is a glimmer of hope that our prediction will reverse in the second half. Will they follow the lead of Warren Buffet who is willing to double up on his US$15 billion solar and wind investment?

9 **Fewer objections to a carbon tax.** We rather ambitiously proposed that some oil majors would start dropping their objection to carbon taxes. We are looking wrong on this one as well. Although many economists are agreed that carbon taxes are preferable to subsides, causing fewer market distortions, politically this is proving too tricky. As for Big Oil, it is busy responding to the issue of stranded costs (Insights Edition 34, 36 & 38). We are not optimistic that we will be proved right in our prediction in the rest of 2014 but investors can satisfy themselves that some oil majors have begun disclosing their carbon price forecasts. Perhaps this is better than nothing?

10 **The emergence of sustainable hedge funds.** On the back of rising ESG investor interest we predicted the emergence of a wave of sustainable hedge funds. This has not happened and stalwarts like Trillium (founded in 1982), Climate Change Capital (2003) and Generation Investment (2004) remain entrenched. There are certainly established hedge funds in specialist areas like renewables, energy efficiency and clean energy (e.g. Ardsley Partners, Arlon Capital, Connective, Hazel, Virid). But for long/short funds with ESG embedded in their investment process, scarcity remains the order of the day. Let's see what emerges in the rest of 2014.

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