

Institutional Investors Energy Transition Investment Policy Options

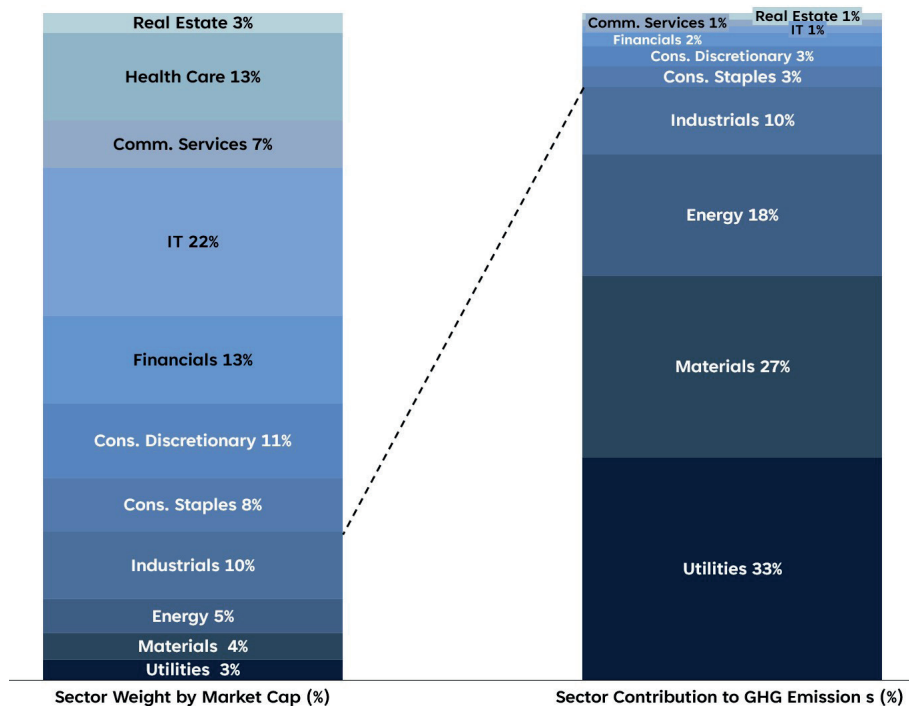
Environmental, Social and Governance (ESG) investing policy must be, in principle, a good idea for all investors to the extent that incorporating potential impacts into the evaluation of investment opportunities may have investors avoiding negative surprises dragging down asset values or have investors exploiting investment opportunities presented by this megatrend. But the term ESG takes on many different meanings with different investors. We find our investment recommendations are clearer when we separate the E from the ESG and specifically discuss the impact of the energy transition on different asset classes, sectors and companies. This is not intended to suggest that other impacts covered under the S and G are less important, but rather that it is more effective to discuss the specifics of each separately.

This note focuses solely on guiding institutional investors in the development of their own policy or plans for investing in and around the energy transition and applies to allocations within all asset classes, but mostly within public and private equity. Many of the strategy options use public equity examples but these do apply to private assets as well.

Why does any investor need a policy for investing in the energy transition?

The future cost of carbon abatement is likely to have a very material impact on approximately 25% of the asset value of public and private equity markets. More specifically, the industrial, energy, materials, utilities and transportation sectors of the public and private equity markets comprise approximately 25% of the value of market capitalisation in the developed world, and account for nearly 90% of emissions.

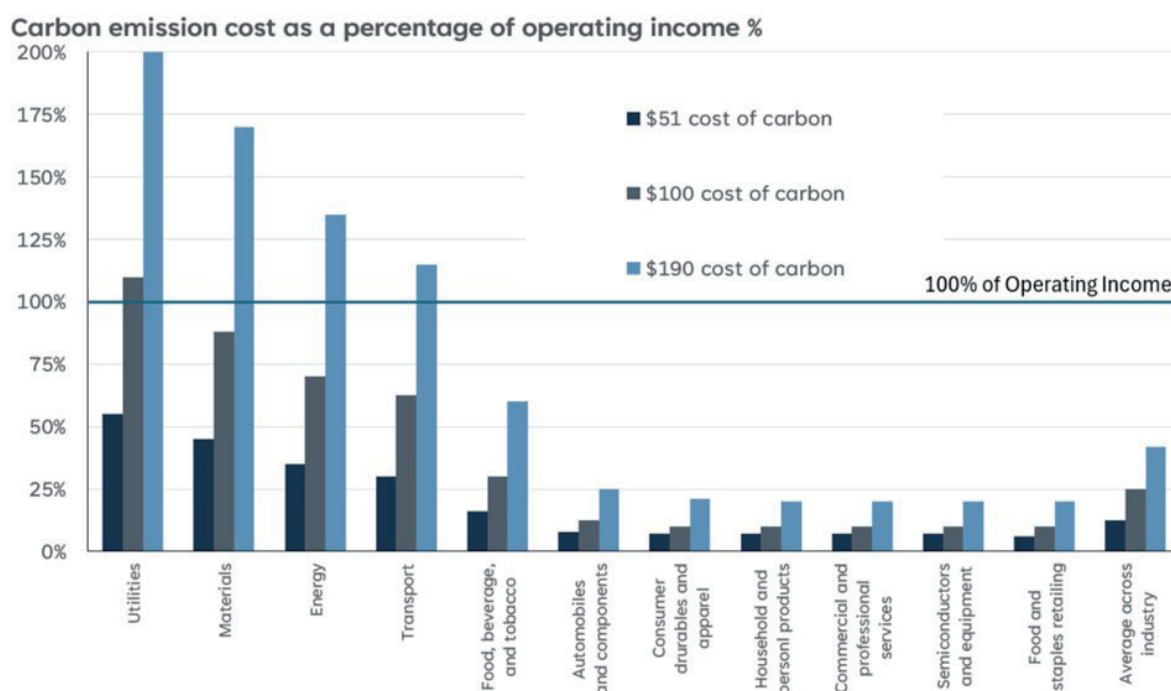
Exhibit 1: 90% of public company emission (scope 1 & 2) are derived from five sectors (adding in the automotive sector) which account for 25% of the market capitalisation.



Notes: Carbon emissions shown here based on each company's most recently reported or estimated Scope 1 + Scope 2 greenhouse gas emissions measured in tons of CO₂ equivalent. Scope 1 emissions are those from sources owned or controlled by the company, typically direct combustion of fuel as in a furnace or vehicle. Scope 2 emissions are those caused by the generation of electricity purchased by the company. Carbon emissions data provided by MSCI, a third-party ESG data provider. Certain information ©2024 MSCI ESG Research LLC reproduced by permission. MSCI World holdings as of 30 September 2022.

Assuming the average cost of carbon abatement will be approximately \$100 per tonne, this suggests that most companies operating in these sectors will see their valuations changing materially as they invest in lower carbon products or processes or choose not to.

Exhibit 2: A \$100 price of carbon materially reduces the profitability of the majority of US energy, materials, transport, utilities, and food companies.



Source: Department of Economics, University of Chicago, Chicago, IL, USA. National Bureau of Economic Research, Cambridge, MA, USA. Booth School of Business, University of Chicago, Chicago, IL, USA. Centre for Economic Policy Research, London, UK. Business School, University of Mannheim, Mannheim, Germany. August 2023 issue of Science magazine. In December 2023, the EPA updated its cost of carbon to \$191/tonne which attempts to include the climate's response and costs of measures to adapt to rising sea levels and higher temperatures. \$51/tonne represents the Biden administration's cost announced in March 2021. \$100/tonne represents the midpoint in the Goldman Sachs analysis of the cost of carbon abatement across all sources of emissions as published in Carbonomics (2023). The research study only included \$51 and \$191/tonne calculations. Partners Capital interpolated the profit impact of \$100/tonne cost of abatement.

Given the materiality of this impact on asset values facing a quarter of the stock market and a similar proportion of the private equity market, investors have had to establish, document and execute investment strategies to address the risks and opportunities of the global energy transition. Ignoring the energy transition and not having a deliberate plan to deal with the transition is an option, but one that has the investor defaulting to having the sum of the actions of its asset managers somewhat randomly determine an institution's energy transition investment strategy. It is our view, based on years of deep interactions with our asset managers and our annual ESG manager survey, that most public and private equity managers do not have sufficient knowledge or expertise on the range of scenarios for how the energy transition will play out.

We recommend that any good energy transition investment policy starts with the assessment of each asset manager's understanding of the energy transition and takes a view on whether their capability is sufficient to avoid the risks and exploit the opportunities presented by the global energy transition.

Beyond this process of manager energy transition capability assessment that we undertake every year in our manager ESG survey process, we attempt to assist our clients by laying out a range of different energy transition investment strategies along a spectrum from a passive approach to one that is actively seeking to move the portfolio to one that owns companies with low or no emissions – i.e., a Net-zero policy.

Energy Transition Investment Strategy Options

We firmly believe that all dedicated long-term investors should develop and articulate a well-defined strategy for investing in the energy transition. This can be guided by the various Energy Transition Investment Strategy (ETIS) approaches outlined below, which are complementary and can be blended in different ways.

ETIS #1: The default energy transition investment strategy has the investor accepting the risks of owning companies in the highest emitting 25% of the market and trusts that most of their existing active asset managers are engaging in very deep analysis of the optimal decarbonisation pathway for each high emitting sector and the companies within them. Their ongoing analysis seeks to identify those companies best positioned to tackle the energy transition risks and exploit the largest opportunities. This may result in a total portfolio over or under-weight allocation to high emitting sectors and to the “green companies” acting as the biggest enablers of decarbonisation, depending on the collective views of all of your asset managers.

ETIS #2: Exclude strategy. This strategy aims to mitigate the risk of holding companies most vulnerable to the impacts of the energy transition. Proponents of this approach believe that the costs of carbon abatement or taxation may not be fully reflected in current company valuations. As a result, they choose to exclude one or more high-exposure sectors, such as energy, industrials, utilities, materials, and transportation. This strategy allows for flexibility in its implementation, ranging from narrow exclusions focused solely on oil and gas, to broader exclusions that encompass other high-emitting industries like utilities, steel, cement, aviation, shipping, automotive, and materials.

Divestment has the unfortunate consequence of defunding decarbonisation. Mark Carney set up GFANZ to ensure we have the financial funding for decarbonisation. The GFANZ (Glasgow Financial Alliance for Net Zero) team would find the biggest boost to decarbonisation finance from encouraging institutional investors to back the biggest public company emitters in their investment strategies. This may go further than any other global action toward financing the global energy transition. To the extent the majority of that financing is expected to come from the large emitters (industrials, automotive, electric utilities), excluding them from the portfolio is potentially making it more difficult to fund the most important and economically viable means of decarbonisation.

Investors following this strategy have to accept the potential for tracking error relative to all-industry benchmarks like the Cambridge Associates PE benchmark or the MSCI World equities benchmark. In essence, they are comfortable with the possibility that these sectors may outperform the broader market in the short term, based on the belief that, over the long run, they will underperform.

Many private and public equity managers today already exclude oil and gas companies, but few go so far as to exclude the other high emission sectors. The “exclude” strategy is best implemented with passive ETFs, index funds or segregated accounts where the investors can be certain of what companies or sectors are included or not.

ETIS #3: Engage with Corporate Management. This involves investing with activist asset managers focused on the energy transition, who have deep expertise around the optimal decarbonisation strategies for each of the major emitting sectors. The aim is to get management to understand the long-term shareholder value improvement that may come from being early to decarbonise in their sectors. Activist manager, Engine No. 1, gained major attention in 2021 when it successfully launched a campaign to replace several board members at ExxonMobil, advocating for stronger environmental strategies and a transition toward renewable energy. While not strictly an activist firm, Generation IM advocate for climate risk integration into corporate strategies.

ETIS #4: Energy Transition as an explicit investment theme. Here, the investor deliberately allocates a specific proportion of total portfolio assets to sectors through generalist and specialist asset managers to back companies with the greatest potential to reduce carbon emissions including both the “Enablers” of decarbonisation (e.g., solar, wind, battery and EV companies) and the “Improvers” or largest industrial decarbonisers (automotive, chemicals, steel, cement, utilities, etc.). Any allocation to one or both of these two groups of companies would be premised on finding and approving one or more high-conviction asset managers who are deep experts in these sectors.

Enablers are companies involved in the production of clean energy or provision of clean energy technology and equipment. The S&P Global Clean Energy Index (CLEN) includes all major constituents worldwide that meet this criterion and includes 99 companies with average market capitalisation of \$8B, representing almost \$800B of potential investments or 0.7% of the global \$120T equity market. Returns averaged 5.3% over the last 10 years with annualised risk of 26.7% for a Sharpe ratio of 0.12. This compares to the global average (MSCI World) of 9.6% average return and a 15% standard deviation, or a Sharpe of 0.5. Clearly broader definitions can be used, but Enablers will still comprise a relatively small portion of the global equity market for some time.

Improvers include any company that is not an Enabler and excludes companies with largely stranded assets (e.g., most oil and gas). This leaves the vast majority of the global equity market companies facing an energy transition to one degree or another. Approximately 70% of global emissions are concentrated with 17% of the global equity market (~\$20T) comprising industrials, materials and utilities. Most of the potential Improvers are found in these sectors including companies like Holcim in cement, Arcelor Mittal in steel, AP Moller in shipping, and Linde in chemicals. Returns over the last 10 years have averaged 7.3% with a standard deviation of 13.7% for 0.39 Sharpe. Improvers comprise companies who account for the vast majority of the nearly \$2T a year invested in global decarbonisation.

The right asset managers will have deep insights into the technology and economics of the Enablers of the energy transition and they will have developed the most economically effective decarbonisation pathways for each subsector of the Improvers such as cement, steel, automotive, pulp and paper and electric utilities. This is not a strategy of simply owning the biggest emitters or decarbonisers, but rather seeks to own those companies where the current valuations do not accurately reflect all the technological, regulatory, economic and customer behavior inputs to a company’s most likely transition strategy. This involves deep insights into the capital and operating cost of lower carbon processes and products and the likelihood of being able to pass such costs on to the customer earning the so-called “green premium.” In some cases, paying the carbon tax may be less expensive than investing in lower carbon processes. The Improver investment strategy simply seeks to own the company where the management team are following the highest shareholder value path to decarbonisation which may include buying carbon credits, paying the taxes or disposing of “stranded assets.”

Alpha will not be generated solely through an understanding of decarbonisation. It will emerge from marrying this understanding with a deep knowledge of sector dynamics, the relative positioning of companies, and the sequence of likely outcomes as technology and cost structures evolve, all translated into long-term cash flow forecasts discounted to the present to be compared to current valuations.

Allocations to this strategy will be mostly guided by the availability of high conviction managers in the Enablers and Improvers space, with the default premise being at weight to the sectors involved. Overweights to this strategy should be in proportion to expected alpha. We presume the investor is unwilling to accept risk-adjusted returns that fall short of what is expected from the asset class more broadly, so any overweight would be in the belief that the alpha would compensate for tracking error over the long-term, but the energy transition impact would be greater.





Many investors focus their over-weights solely on the Enablers of the energy transition and avoid the high emitting companies. As described above, the cleantech sector represents a small and volatile 0.6% of the global equity market, while the major decarbonising sectors account for approximately 17% of the global equity market as we show in Exhibit 1 above. Investors in the Enablers in recent years have suffered poor returns as they included smaller tech companies which experienced bubble formation and bursting cycles. On the other hand, the Improvers tend to be in the most highly cyclical sectors, but with much lower volatility experienced than for the green sector of enablers.

Sovereign wealth fund, GIC (Government of Singapore), publishes its approach to sustainable investing which contrasts with a rigid, top-down strategy that divests from entire industries without considering their individual circumstances or potential for positive change. GIC emphasises contributing to real-world decarbonisation, rather than focusing solely on portfolio decarbonisation (i.e., exclusion or divesting).

Milestone goals would be set in the form of total tonnes of GHG emissions reduced and avoided over time by the companies owned, including scope 1 and 2 emissions for most sectors, but adding scope 3 for automotive and certain engineering companies (e.g., manufacturers of gas turbines).

Exhibit 3 below summarises the options laid out above. These options are by no means an exhaustive list of potential energy transition investment strategies. However, we firmly believe that investment performance can be materially positively impacted where the investing institution’s investment committees or other decision makers take the time and mental energy to arrive at the best strategy for their portfolio.

Exhibit 3: Energy Transition Investment Strategy Options: There is no one “most sensible” way to invest. Investors benefit from taking a clear view on which approaches best fit their investment objectives.

Energy Transition Investment Strategy	Exclude	Engage	Invest in Solutions (Enablers)	Invest in Improvers (Leading Decarbonizers)
				
Description	Avoid investments in companies most likely to suffer from the ET or where it is simply most uncertain	Own stakes in biggest emitters and engage with management to invest in carbon abatement	Focus on the companies producing the technology that will enable decarbonization (renewables, EVs, batteries, etc.)	Invest in the largest GHG emitting companies who have a strategic advantage in decarbonizing their businesses faster and at lower cost than competitors.
Case for Alpha Generation	Taking a view that the cost of carbon abatement has not been fully discounted into the value of the biggest emitters	Successful engagement efforts motivates management to do things resulting in positive shareholder view and re-rating.	Have genuine insights into which technologies and tech companies will have the largest market and competitive moats	Have genuine insights into which companies are in the best competitive position to abate GHG from their businesses
Issues	<ul style="list-style-type: none"> Tracking error (i.e., oil and gas, utilities, industrials outperform the overall index) Effectively “defunding” the energy transition by not investing in the biggest emitters. 	Management takes the short-term view in the name of increasing short term shareholder value	Has been a highly volatile sector with sentiment driven bubbles followed by poor performance driven crashes.	Too complicated to assess the path of the energy transition and likely cost of carbon abatement for any one company.

Source: True North Institute

All four strategies above are relevant to how allocators invest in public as well as private companies.

A pragmatic approach to Net-zero emissions goals for investors

Net-zero goals apply to countries, companies, asset managers and asset owners. It is not controversial that countries and companies should set Net-zero goals and design and implement plans to achieve those. Plan by large emitting companies will most powerfully drive the global energy transition. The virtue of Net-zero goals for investors is controversial. Currently, about 53% of European pension funds have committed to achieving net-zero carbon emissions by 2050. A smaller portion of funds has set more ambitious targets: 14% aim for Net-zero by 2035, and 18% target achieving this by 2040. The U.S. pension industry is gradually aligning with global efforts, with some leading funds targeting 2040, while many aim for 2050. However, U.S. pensions generally trail behind European funds in net-zero commitments.

There are two ways institutional investors and asset managers think about Net-zero goals -- my portfolio holds no companies with carbon emissions or my investing activity creates real world decarbonisation.

Net-zero achieved by decarbonising my portfolio: When Net-zero goals were first being embraced by investors, the thinking was that if the investor divests from carbon emitting companies, this can accelerate their extinction and accelerate decarbonisation as a result of raising their cost of capital and discouraging talented management from working for them. But we reiterate that divestment has the unfortunate consequence of defunding decarbonisation

“Divestment has the unfortunate consequence of defunding decarbonisation”

Net-zero achieved by contributing to real world decarbonisation: As with all new things in the investment world, investment thought leaders have evolved their thinking about Net-zero goals after more careful thought and some recently published research on the negative impact of exclusion on emissions. Two examples follow, both of which focus on real world decarbonisation rather than “portfolio decarbonisation.

The Singapore sovereign wealth fund, GIC, states in their Sustainable Investing Strategy, “While portfolio decarbonisation can be achieved through divestment, GIC prioritises tangible impact in the real world.”

The Norwegian sovereign wealth fund manager NBIM states in their 2025 Climate Action Plan, “at the heart of our efforts is driving portfolio companies to Net-zero emissions by 2050 through credible targets and transition plans for reducing their scope 1, scope 2 and material scope 3 emissions.... We believe that companies that understand the drivers of Net-zero emissions and anticipate regulatory developments will be well-positioned to capture the financial opportunities arising from a low-carbon economy. While some high-emitting companies may decline in value, others will transform their business models and grow among the greening companies supporting an orderly transition..... We believe that our engage-to-change approach will yield the best financial results for the fund. It will also contribute to improved real-world outcomes..... Working towards a Net-zero 2050 target for our portfolio companies gives a strategic direction for all our climate activities.”

These two examples manifest a combination of all four strategies above. GIC, for example, excludes assets they deem to be “stranded assets” which are assets with a high risk of becoming obsolete due to their high carbon intensity which they estimate to be 10% of the MSCI. They invest in “green assets” which align with what we describe above as “enablers”, and represent about 7% of MSCI. But the remaining 83% are all considered to be “transition assets” which includes what we refer to as “improvers” above but also companies in low emitting sectors. “GIC engages with transitioning companies to understand their transition plans, assesses the viability of supporting their transition with capital, and evaluates the risk/reward profile of such investments.”

A Net-zero portfolio policy proves to be impractical over anything other than a very long time frame. A short

time frame forces the investor to sell the largest emitters before they have been able to make all of the investments required to transition to low emission products and processes. Selling early on only raises the biggest potential decarbonising companies' cost of capital and discourages the best management teams from joining such companies to manage the most effective decarbonisation plans.

This is how that works. The average carbon intensity as measured by CO₂ equivalent tonnes of carbon per million dollars of market cap is approximately 80 tonnes/\$1M market cap. A Net-zero portfolio needs to get to 0 tonnes/\$1M market cap, usually set for 2050. Targets set too early relative to what the real world can achieve, forces sales of high emitters (e.g., electric utilities, steel companies) which are among the biggest investors in the energy transition. A better set of interim metrics would be to measure the real-world reduction in emissions by the companies during the period of ownership with ambitious targets set for that metric. This focus on real world decreases in emissions by the companies owned, motivates the asset owner to engage with that company and to make sure the companies bought in the first place are those who appear to be maximising shareholder value through the right decarbonisation plan for that company.

The most pragmatic Net-zero investment strategy involves taking a long-term investing time frame and investing with asset managers who are ahead of the pack in terms of understating the best decarbonisation pathways for each industrial sector, measuring the change in emissions at the company level, to see real world decarbonisation, not portfolio decarbonisation. These managers may also have the capabilities required to effectively engage with management teams on their decarbonisation strategies.

How should institutional investors set goals for overall portfolio asset allocations to the Energy Transition?

The energy transition is an investment theme primarily limited by the availability of high-caliber specialist managers who possess the expertise needed to navigate inefficiencies in the market created from uncertainty around how technology, regulation, and customer behaviour will ultimately impact asset values. This approach is no different from how investors approach sectors like life sciences or emerging tech, relying on niche insights to gain an edge. With full awareness of the risks, we embrace a measured overweight to energy transition sectors, anchored in the belief that specific generalist and specialist managers can deliver alpha.

For most institutional investors, allocations to specialist energy transition managers should be the natural outcome of the broader portfolio management process. This includes selecting managers with the highest alpha potential, within the usual constraints of sector exposure, asset class/beta allocations, correlations, and alpha volatility—while adhering to any other overarching portfolio construction guidelines. This approach assumes that the investment policy does not mandate specific impact targets or prioritise the energy transition as a central theme.

Chief Investment Officers (CIOs) should engage their investment committees in discussions about the role of the energy transition within their portfolio strategy. If there is a preference for overweighting allocations to energy transition-focused managers, specific percentage targets can be set based on risk-adjusted return objectives. In practice, this means that when risk-adjusted returns across managers and sectors are comparable, a modest overweight to energy transition managers can be justified.

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True North Institute



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