ADDENDA CAPITAL

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Fossil Free: Don't Take the Shortcut

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Campaigns urging investors to go fossil free certainly got the conversation going about the financial sector's role in the path to climate transition. But considering what needs to be done here in Canada to bring down emissions, is it the right move?

While we understand that for some, this decision is based on ethics and values, we think that divestment is a last resort because it:

- Fails to constructively engage companies on the steps necessary to reduce greenhouse gas emissions (GHG)
- Targets emitters and/or producers instead of considering the larger issue that is the economy's overall reliance on fossil fuels
- Overlooks a fact that would shine a different light were it reminded more often: independent oil and gas companies represent only 30% of world output, which means state-owned producers could feel even less pressure to show transparency

Addenda's end goal is one shared by those who promote divestment: a net-zero emissions society by 2050. But we believe investment managers have a unique opportunity. They can **use capital as leverage to make a real difference in the transition**, that is by fostering meaningful engagement with companies to urge them to reduce emissions while still earning compelling risk-adjusted returns for clients.

This is what drives us, and it is why we are taking the next step by launching the Addenda Climate Transition Canadian Equity Pooled Fund and the Addenda Climate Transition International Equity Pooled Fund.

Staying at the Table

Countless investors have consciously opted primarily not to divest. According to an international survey conducted in 2018 with 439 institutional investors[1], including asset managers, banks and pension funds, "divestment was the least used course of action when investors were dissatisfied with firm responses to their engagement (only 17% exited under such circumstances)". Others engaged even further (21%), chose to hedge the risk (23%) or took no action (40%).

For example, the world's fourth-largest foundation, the UK's Wellcome Trust ($26 B£ AUM), recently said it is rather choosing to be an "active investor"[2] instead of going through with a "one-time divestment". This allows its leadership to actively engage with companies that have drawn a pathway for transition measures — an engagement that Wellcome Trust calls "being in the room" —, but also to divest when faced with management that is not making the required effort.

Bear in mind that independent oil companies, which are clear targets for social pressures and investor sentiment, only represent about 30 percent of global oil and natural gas supply. But as the Expert Panel on Sustainable Finance wrote in 2019[3]: "Divestment from these public companies essentially transfers market share from the minority producers most obliged to act responsibly and transparently, to monopoly producers without similar obligations." Or, as one managing director mentioned in that 2018 survey of 439 investors, "if we divest, other investors will buy the stock and nothing will change". Ultimately, the impact on global fossil fuel supply is marginal.

A Holistic Transition

Part of what drives the divesting debate is the idea that shutting off the valve of capital will lead to a carbon-free world by gradually constraining fossil fuel financing and future development of reserves. We approach this with a larger perspective on the issue.

The divestment campaign skirts the transition that Canada itself will need to implement, a shift requiring massive investment combined with careful planning in order to maximize impact. Thousands of jobs are at stake, not to mention companies and sub-sectors that still rely on petroleum products as inputs. In 2019, the three economic sectors most responsible for greenhouse gas emissions in Canada were oil and gas (26% of overall emissions), transportation (25%) and buildings (12%).

Companies across the board have already laid out the heavy lifting required for the transition. At Canadian National Railway, for example, management has recognized "the need for new locomotive propulsion technology to meet the deep decarbonization required to achieve a net zero emissions by 2050", it wrote in its 2021 information circular[4]. "We also recognize the importance of collaborating with governments, supply chain partners, universities, cleantech, fuel producers and locomotive/engine manufacturers in achieving an effective transition to a lower carbon future. […] Discussions on the prospects of rail electrification and hydrogen power trains are already underway."

But this transition work, in many cases, will need support from investors, and this is where the financial industry plays a crucial part. "While the Government has put forward a plan and key policies to underpin Canada's transition to a low-carbon economy, the role of financial markets in driving this change has yet to be fully leveraged," the Expert Panel on Sustainable Finance wrote in its 2019 report[3]. "Our financial sector houses essential expertise, ingenuity and influence that can be brought to bear in meeting the challenges posed by climate change."

The Path to Follow

The fact that the concept of divestment is now widely embraced highlights that human activities need to change — which will lead to a radical retool of our daily lives — and that a move to a lower carbon world is not only desired, but necessary. Those that enthusiastically embrace divestment ultimately consider it as a critical step in the economic transition away from a global economy largely run on fossil fuels.

We offer a more constructive strategy and urge you to follow our lead. Our approach to climate transition has been to shun the concept of blanket divestment. Our focus is on how we, as investors for our clients, can invest in ways that encourage, and hopefully accelerate, the necessary transition while at the same time continuing to meet client requirements of competitive risk-adjusted returns.

Addenda's end goal is one shared by those who promote divestment: a net-zero emissions society by 2050.

[1] The Importance of Climate Risks for Institutional Investors
[2] Mental health, climate and disease: Wellcome Trust's Director of Strategy on tackling our big health threats
[3] Final Report of the Expert Panel on Sustainable Finance
[4] CN Essential — Management Information Circular and Notice of Annual Meeting of Sharholders