Decatur Capital Management, Inc. September 2019 Issue 3, Volume 1

DECATUR ESG IMPACT REPORT

GLOBAL PROXY TRENDS
Environmental, Social, & Governance Impacts

Investment Returns & Climate Risk Disclosures

As an investor, I attempt to model risk factors and treat climate risk as a factor. So, I will not address the science or legal issues regarding climate risk. First, a definition of climate risk is important. Climate risk is the impact on a corporation's financial performance based on the current and future effects of climate change – which can be referred to as physical risk and transitional risk. The physical risk addresses damage based on the impact of carbon emissions on the environment. An example is the impact on insurance companies that have to underwrite coverage for properties in coastal areas that are experiencing an increased number of catastrophic flooding and storm events.

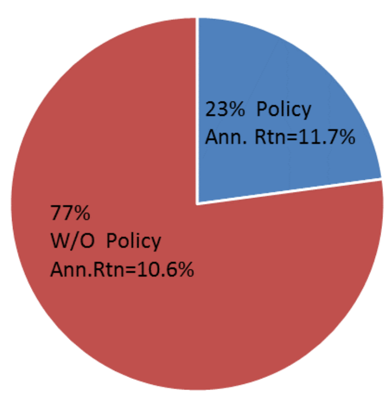
> …CLIMATE RISK MAY BE MISPRICED DUE TO SHORTCOMINGS IN THE AVAILABLE INFORMATION.

The transitional risk is the risk from moving the current emission levels to a future of lower emission levels. An example is the impact on energy firms that are focused on fossil fuels, which may see reduced revenues as the preference for alternative energy sources increase.

Predicting the timing of the impact of climate change is difficult; however, we have observed the change in firm behavior related to climate change has already started to occur. Therefore, we measure the climate risk impact on our clients' investments.

The initial step is to measure the baseline carbon emissions. This measures the total amount of greenhouse gases that are emitted into the atmosphere directly by the corporation, indirectly by purchasing energy, and other indirectly outsourced activities. In order to compare across firms, we measure the carbon emissions as metric tons per $1 million of firm's revenues. This is referred to as carbon intensity.

Chart 1: Russell 3000 Firms – Emission Policy, June 2016-2019



Source: Russell 3000, Refinitiv, Decatur Capital Management, Inc.

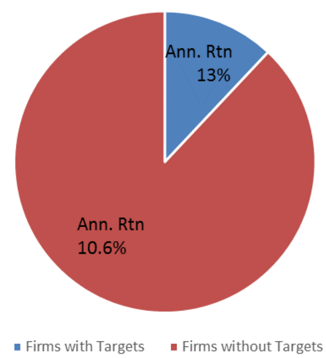
We analyzed 3000 listed U.S. firms that are members of the Russell 3000 Index which represent about 98% of all U.S publicly traded companies. A number of corporations are voluntarily providing material emission information to investors. Chart 1 shows the number of firms that have an emission policy is approximately 687 or 23% of firms. The firms with an emission policy, over a three year period, 2016-2019, earned 11.7% annualized return compared to the firms without emission policies earned 10.6%, an excess annual return of 1.1%.

A further step is to identify stranded assets; this is similar to the treatment of impairment of assets and takes into account regulatory, economic, and physical effects. Currently, stranded assets are fossil fuel supplies that will have a lower economic return as a result of the transition to a low carbon economy sometime in the future. The number of firms that are reporting their emission targets is approximately 361 or 13% firms in the Russell 3000. Chart 2 shows that the firms that report their emission targets had an annual return of 13% compared to 10.6% for firms that did not report their emission targets. Among the 186 energy firms that we evaluated, 7 or 4% have emission reduction target policies. Several of these firms use climate change scenario analysis to forecast the impact on their financial performance which is a material issue to shareholders and investors.

Many firms have turned to organizations such as the Global Reporting Initiative to provide guidelines. The Global Reporting Initiative (GRI) is an international independent standards organization that works with corporations and governments to understand and communicate the impacts of climate change.

If firms are required to report their current level of carbon emissions, stranded assets, and transition plans this will provide shareholders with material information to evaluate the physical and transition risks.

Chart 2: Russell 3000 Firms - Emission Targets



Source: Russell 3000, Refinitiv, Decatur Capital Management, Inc.

We continue to evaluate methods to price the environmental impact on stock prices. We have found that firms reporting their emission policies and targets outperform other firms.

In addition, we have found that those firms with positive environmental news, including carbon emissions and air quality, compared to firms with negative environmental news outperform one year later. Based on our research, we have found climate risk to be a material item in making investment decisions. [1]

1 This article is based on the Written Statement by Degas Wright, CFA. Decatur Capital Management, Inc. to the U.S. House of Rep. Committee on Financial Services. Subcommittee on Investor Protection, Entrepreneurship, & Capital Markets. July 10, 2019.