Janus Henderson
INVESTORS

HOW CAN DC INVESTORS PLAY AN ACTIVE AND MORE MEANINGFUL ROLE IN DECARBONISATION BY INVESTING IN THE RESOURCES SECTOR?

The energy transition needed to address climate change will require significant investments in new resources capacity to ensure the efficient rollout of low-carbon technologies. But ensuring that Defined Contribution savers play their role in supporting this sector over the coming years will require the pensions industry to look beyond the carbon profile of its portfolios and acknowledge the key role the natural resources sector is set to play over the coming decades.

Key takeaways:

- Annual demand for critical minerals to support decarbonisation initiatives is set to nearly quadruple by 2040, according to the International Energy Agency
- Mining companies have yet to materially lift investments in new capacity despite the anticipated rise in demand
- Investors can still achieve significant decarbonisation by blending investment in best-in-class sustainable resources firms within a Paris Agreement-aligned portfolio

Arguments about how best to address climate change continue to rage, but there's no denying that creating a lower-carbon world will require a significant overhaul of the global economy and the energy system that underpins it. From replacing internal combustion engines with electric alternatives to generating renewable power from solar and wind energy, the steps countries need to take to meet the Sustainable Development Scenarios to limit global warming to the 1.5°C ceiling set out in the 2015 Paris Agreement will touch on nearly every aspect of daily life.

For Defined Contribution (DC) savers, the energy transition offers significant opportunities to enable decarbonisation over the coming decades – along with risks that member assets could be stranded in high-carbon investments. But whilst many pension plans have been focused on investing in firms with higher ESG ratings and lower carbon profiles, little thought has been given so far to the vast quantities of critical enabling raw materials to build the low carbon economy. The green energy transition relies on sourcing enough of these fundamental building blocks because without these natural resources, there can be no low-carbon future.

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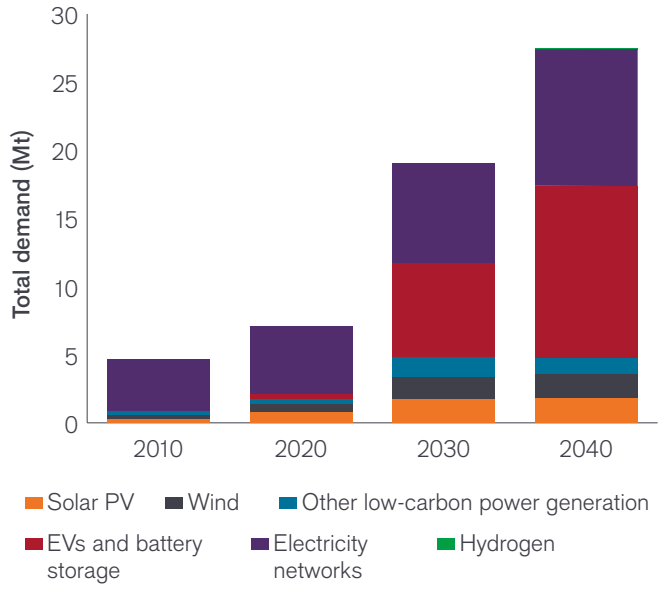
Sustainable resource demand to surge

The scale of the upcoming resources challenge was made apparent in a recent report by the International Energy Agency (IEA) on the level of resources needed to support critical decarbonisation initiatives. Overall, the global energy body estimates that countries will have to source over three and half times the total demand from the same end markets in 2020 every year by 2040 to keep track with decarbonisation targets.

Fig. 1: Transition-linked mineral demand and forecast to meet climate pledges



Source: International Energy Agency, as at May 2021

Note: Includes copper, major battery metals (lithium, nickel, cobalt, manganese and graphite), chromium, molybdenum, platinum group metals, zinc, rare earth elements and others, but does not include steel and aluminium. There is no guarantee that past trends will continue, or forecasts will be realised. The views are subject to change without notice.

Resource demand expectations for electric vehicles

> "The IEA expects the demand linked to electric vehicles and battery storage to be the most resource-hungry market – forecast total yearly demand rising from less than half a million tons in 2020 to over 12.6 million in 2040 according to the energy watchdog. This is made up of a wide mix of materials, many of which already face supply constraints. In fact, the forecasted 3.3 million tons of additional yearly nickel demand for this end market alone dwarfs the current 2.8 million tons of nickel produced annually, underscoring the pressing need for investment in new capacity."

Investment in transition-enabling resources is lagging

Despite the obvious pressing need to ramp up supply to meet the demand associated with decarbonisation, global resources firms have yet to materially lift investments in new capacity after a decade of underinvestment that followed the peak spending in 2011 induced by the China-led demand for resources boom. Most worryingly for the prospects of achieving decarbonisation goals and meeting global warming targets, is that there appears to be no plans to snap out of this period of chronic industry underinvestment. Figure 2 shows that analysts are forecasting near-term investments in new capacity across the sector to run at about half the pace seen in the 20 years that preceded the peak of China's hunger for resources.

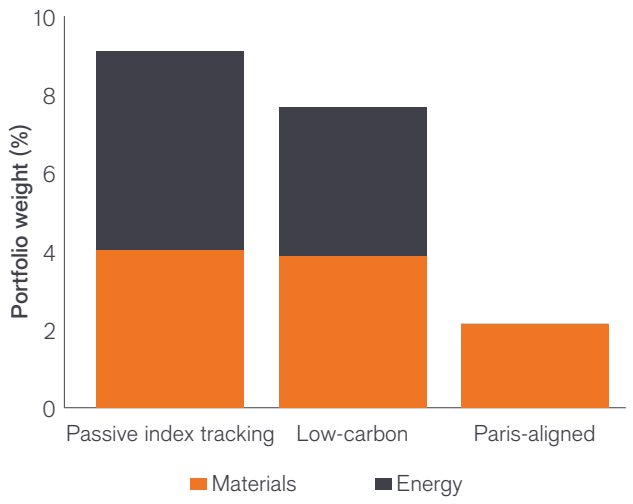
Fig. 2: Real global mining capex (bn USD) per unit of mine production (indexed to 1990)

Source: Jefferies, August 2023

Many equity investors ignoring the role or resources in the climate transition

For their part, many equity investors are also unprepared when it comes to investing in resources ahead of the low-carbon transition. The ongoing drive to lower the carbon profile of portfolios – with low "carbon tilted" indices or Paris-aligned benchmarks – means many equity portfolios are now underweight the resources sector at a time when the sector's capital needs are set to surge to meet the demands of the low carbon economy. Indeed, Figure 3 shows that both "Paris-aligned" and "low-carbon" approaches to equity investing have significantly less resources exposure that passive index tracking, with investors following the former strategy committing to having no energy investments and about half the materials exposure. DC plans are especially exposed to this as all five of the largest master trusts with publicly-available asset allocations allocate to low carbon or Paris-aligned benchmarks for some or all of their equity allocations, according to our research.

Fig. 3: Resources weight by investment strategy (%)



Source: MSCI, September 2023

Indexes used: MSCI World, MSCI ACWI Low Carbon Target Index and MSCI World Climate Paris Aligned Benchmark Select Index.

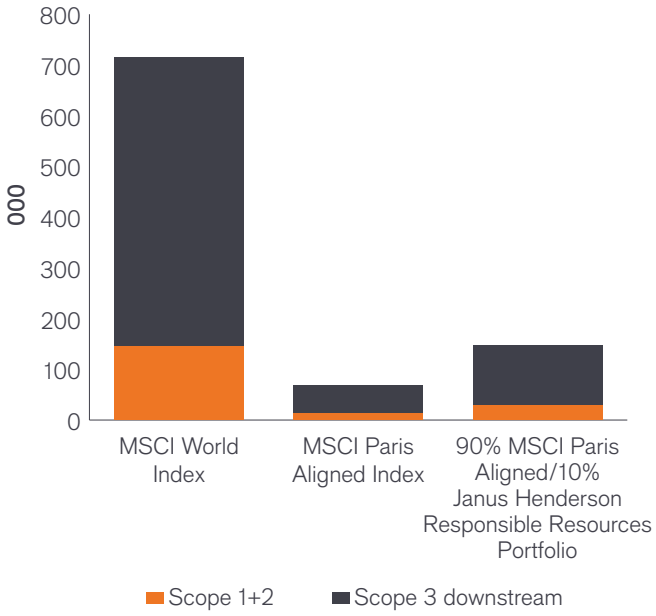
Being underweight the resources sector may have made sense given these stocks lagged the wider market during the low-growth decade that followed the Global Financial Crisis. However, this position needs to change if investors want to play an active role in funding this key enabler of the low carbon transition.

A holistic approach to delivering a climate transition investment portfolio

We are advocates of DC trustees adopting a more holistic approach to decarbonisation by looking at the wider picture of how this can be achieved rather than purely focusing on low-carbon companies and Scope 1-3 emissions within portfolios. It is essential to acknowledge the critical role materials play in facilitating a low-carbon economy. Currently, the "scope" lens applied to gauge the carbon profile of investments puts resources at a disadvantage in the eyes of carbon-conscious investors due to the carbon-heavy nature of the sector. Measures to acknowledge the role a company's products and practices play in avoiding emissions (Scope 4 emissions) are starting to gain traction. A greater adoption of these metrics will help highlight the key contribution resources firms play in decarbonisation efforts.

Rethinking resources also doesn't have to tie investors to firms with poor ESG profiles. The sector overall has made great strides in improving its sustainability characteristics – both in terms of how new resources are mined and produced, but also with firms that are playing a leading role in the circular economy. There's no running away from the fact that even sustainable resources companies will have higher carbon intensities than those of low-carbon indices. However, investors can still achieve a significant reduction in the carbon profile of a portfolio relative to the overall market by taking a blended approach that mixes investments in responsible resources with other low carbon equity investments (Figure 4).

Fig.4: Total carbon emissions tons CO2e / $M invested



Source: Janus Henderson and MSCI, July 2023

Closing thoughts

The unprecedented challenge posed by decarbonisation requires significant investments to enable the rollout of low-carbon solutions required to meet global climate pledges. These investments also need to filter through to supply chain participants to ensure technologies can be rolled out at the required scale. The post-COVID economic reopening has shown how even a few bottlenecks can quickly hobble entire industries.

Given the high stakes involved, investors need to ensure that capital flows through to the fundamental building blocks that will make the energy transition a reality. Finding a way to properly account for the role companies play in enabling low-carbon technologies should put the resources sector in a better light in the long run.

In the meantime, investors should look beyond the carbon profile of their investments and ask whether their capital is 'doing good' by playing an active role in enabling a low-carbon future. Acceptance of a slightly higher carbon profile with the potential for better returns could be a better outcome for beneficiaries than simply investing in a low-carbon portfolio that makes them feel good.

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