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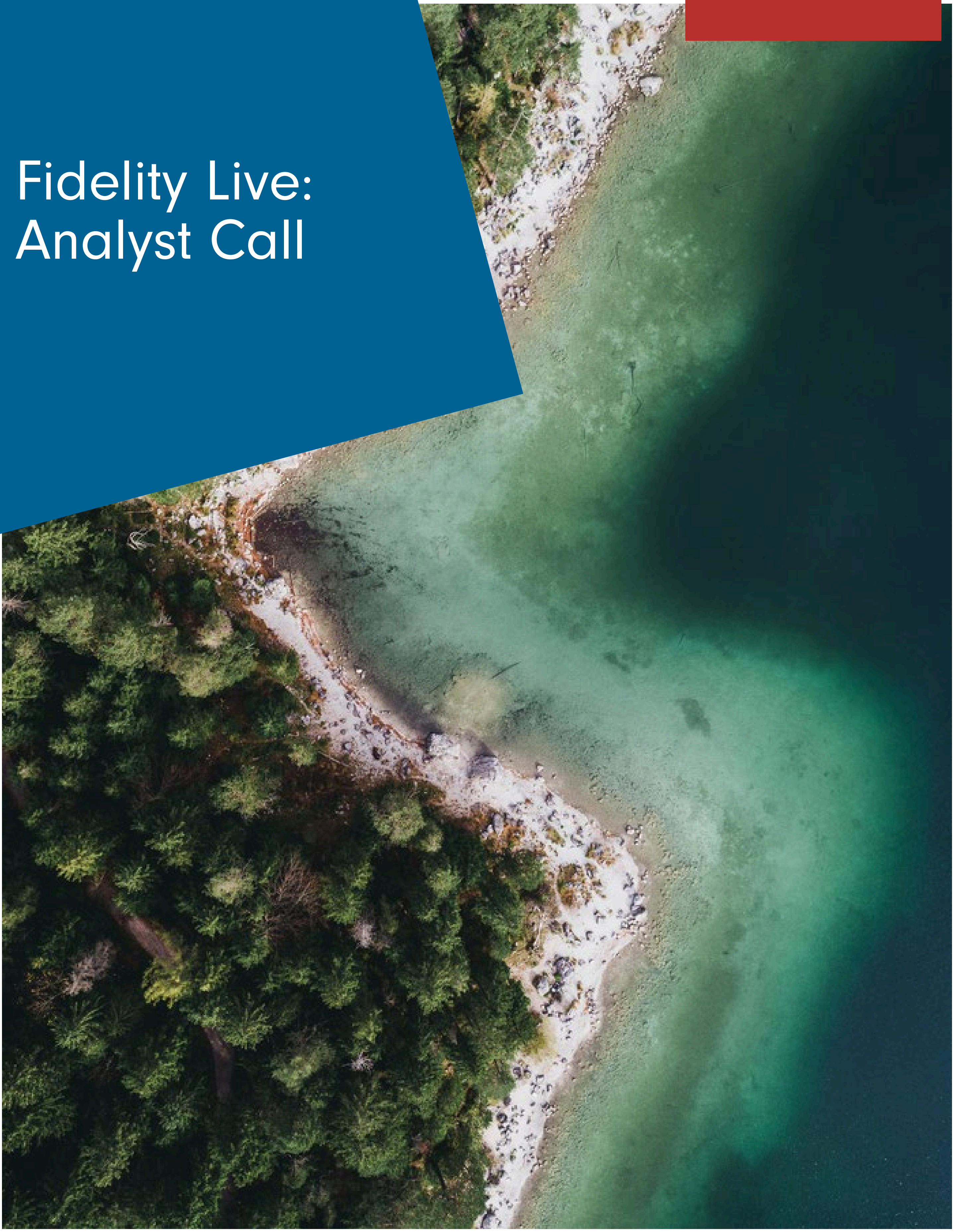
Fidelity Live: Analyst Call



Investment Professionals

Moderator:

Richard Edgar, Editor in Chief

With:

Ned Salter, Head of Equities, Global Research and Asia ex-Japan Investment

Alicia Daurignac, Fixed Income Analyst (Utilities)

Alex Laing, Equity Analyst (Utilities) & Co-Portfolio Manager

- We have increased our focus on environmentalissues, particularly regarding the mission to reach 'net zero'.
- Both equity and fixed income investors shouldconsider corporate engagement as key in thebroad push towards decarbonisation.
- We have published an updated voting policythat formalises aspects of our approach to specific sustainability issues.

Today, we are discussing some of the issues around the mission to reach 'net zero' carbon emissions. We will talk about how we are integrating the net zero target into our investment processes at Fidelity, as well as how we engage with companies on climate issues and the results we are seeing. Ned, can you please set the scene?

NS: I'd like to focus on two of the main initiatives we are undertaking. The first is our new voting policy (released in June), which further formalises our active ownership principles and the framework through which we apply them. The primary goal of our engagement is to improve corporate behaviour and reduce the risks associated with sustainability, particularly regarding social and environmental issues.

The policy is aligned against twelve subjects over four broad categories: philosophy and behaviour, management governance and transparency, impacts and responsibility, actions and use of capital. On each of these issues, we think carefully about actions that are appropriate and what we will vote for and against. For example, we will vote against companies that don't have climate change policies, those that don't share their emissions data, and those don't have adequate oversight of the climate change issues they face - we believe all our investee companies should publish descriptions of the climate risks and opportunities associated with their businesses and have strategies for managing these. We also expect companies to undertake scenario planning - i.e. detailing actions that will ensure they adhere to the 1.5°C climate pathway set out by the Paris Accord. We make companies are aware of our expectations and will start voting against those that don't meet them from 2022.

In terms of other sustainability issues, we have a focus on gender equality and will vote against developed-market companies that do not have at least 30% female representation at the board level (15% in the emerging markets). Regarding governance issues, we have established explicit director and auditor independence guidelines. We have also established guidelines to help foster sustainable practices more broadly among all of our investee companies.

The second key initiative we are undertaking addresses the path to net zero. We are a founding signatory of Net Zero Asset Managers Initiative, which seeks to ensure that all investment funds are 'net zero' (across scope 1,2 and 3 emissions) by 2050. We have also brought forward our own net zero target date from 2040 to 2030 (covering our own operational activity), which includes a commitment to reach net zero across our real estate business by 2035.

To accomplish our climate goals, we use direct engagement to encourage investee companies to reduce their greenhouse gas emissions via efficient energy management practices, substitution (i.e. with low carbon technologies and renewable power), and compensation (where emissions are unavoidable). We approach engagement in different ways - via idiosyncratic bottom-up engagement with individual companies, but also thematic engagement at a broad level. The latter ensures that our broad corporate objectives are reflected in our engagement activity and allows us to achieve scale in our engagement activity. If necessary, we will collaborate other investment managers on engagement; we are not simply seeking to gain credit for sustainability – we are looking to make a positive contribution towards a more sustainable world.

Regarding the new voting policy - this appears to be a coordinated approach across the company and seems like a statement of intent, is that right?

NS: Yes absolutely. Voting has to move as quickly as engagement activity. In years gone by, voting policies might have focused on capital allocation (i.e. M&A) and remuneration, but these governance issues are no longer the only activities that matter. Today, social and environmental factors are more important than ever and investors should consider all risks across the capital structure, not just for equity investments.

Does having such a rigid voting framework have the potential to damage Fidelity's relationships with corporate management teams?

NS: There is often a reluctance to vote against investee company management, as the decision to deploy capital to an investee company is an expression of support for the business and management, so it can be counterintuitive to 'vote against'. However, voting against should be considered as another form of engagement; it can act as a conversation starter and a way for aninvestor to 'put their money where their mouth is'.

What is the balance between change that is brought about by regulation and change that's catalysed by engagement?

NS: The regulatory push is great as this will force changes in corporate behaviour. However, the 'consumer pull' factor is also important (for example, if it means a shift in demand from internal combustion engines to an alternative drivetrain). Asset owners can also have a positive impact on sustainability - whether a pension fund or an individual retiree. The overall goal is to changecorporate behaviour - everyone has a role to play. It is important to note that we are not here just to create sustainable portfolios - that's easy; we are trying to create a sustainable world, which is more complex.

Alex, how quickly are utilities moving towards the net zero goal?

AL: Utilities are interesting as they typify climate change - if this issue is being discussed on the news the first image they will often show is that of a power station. However, utilities are one of the greatest climate change success stories. In the early 90s the power sector was generating just over a third of global emissions, but now it is under a quarter; emissions have almost halved per megawatt generated over that period.

There have been two drivers of this success. The first is regulatory push, with more carbon-intensive technologies like coal having largely been phased out. The second is that the economics have changed - the force of capitalism; it is now much cheaper to install renewable power than any form of thermal generation. Certainly, when you look at Western utilities there is very little investment in thermal power - not quite zero and there is still thermal investment in the emerging markets where there are fewer realistic alternative options. 90%+ of developed world capital investment gets directed towards renewables, as renewable investment reflects better in share prices. If a company can invest $1 and get $1.5 on its share price it's a no brainer - this is a change that the investment community has fostered that supports the switch to renewables.

Alicia, Ned alluded to the fact that we think about engagement being more closely associated with equities, but how does it work in fixed income given that you are not necessarily a shareholder and therefore might not have opportunity to vote?

AD: Bondholders still have a lot of weight with management, particularly in the utilities sector where there is regular debt issuance. Many companies issue at least once a quarter, so they are obliged to align with bondholders' ideals. We have conversations with managers about issues like capital allocation and their broader sustainable strategies, and if companies are notin line with our expectations we can lend elsewhere. Such decisionscan affect companies' cost of capital, so they are incentivised to keep bondholders happy. At Fidelity, we have very strong corporaterelationships so we are in a very good position to affect change.

Taking a question from the audience - when you engage with companies, why don't you collaborate with other asset managers?

NS: In short - we do. In the first instance, a lot of asset managers collaborate through organisations, but there is also a lot of scope for direct collaboration. It isn't important who is asking the questions, so long as behaviour improves - the questions we are asking / improvements we are seeking are similar to those being sought by other shareholders.

You might have heard about our initiative regarding stranded seafarers during the pandemic. We wrote a letter to the UN that ended up having 85 other asset managers supporting as signatories. These other managers were not competing for credit,but collaborating to ensure that positive and beneficial action wastaken. I think more of this kind of investor behaviour is needed.

Alex and Alicia - can you provide examples of how you have worked with other asset managers in a similar manner?

AD: This kind of collaboration is common. When new bonds issued, we usually jump on calls with other investors and management, so we constantly see what issues are being discussed. We are often all focusing on the same issues, so in a sense this is ongoing collaboration.

AL: This kind of action can have a powerful effect on corporate behaviour. We saw this in the case of Exxon Mobil recently; this was pretty much the sole major player in the energy industry that was resisting the push into renewables, but we saw a minor investor take a very small stake in the company and subsequently rally sufficient support from other shareholders to put emissions reduction on the table at the board level of the largest energy player in the world. The company's larger investors perhaps wouldn't have raised these issues themselves.

Alex, you mentioned thermal coal - is its use likely to continue in China?

AL: One of the biggest climate issues is China and India's continued investment in coal. The trouble is that they don't have a dependable, cost effective alternative, but there is obviously a necessity to maintain a reliable power supply. Batteries aren't good enough to store the necessary energy at present, given cost constraints. The alternatives are nuclear and gas, but these pose economic problems that mean investment in coal is still occurring. Nevertheless, the economics of renewables are becoming more attractive and in the next ten years I believe these will be sufficient to catalyse a broader shift towards renewables. China's political structure will likely also assist - its leadership has already committedto a 2060 net zero goal.

NS: The important factor we need to consider regarding thermal coal is transmission potential - the potential to shift away from thermal power given dependency on it. This should be considered a both the bottom up level and the aggregate level for society. It is particularly important to make these considerations in the emerging world.

How has the management of corporate governance evolved from the past?

NS: There is more accountability - both for our investee companies and ourselves. Our new voting policy establishes explicit responsibilities and ways we must vote on certain issues. This is important as it allows us to draw a line in the sand on important issues and provides a benchmark to measure the results of our engagement in retrospect.

Ned, you have talked about Fidelity's own standards - what level of input do you have in terms of Fidelity's drive to become carbon neutral or negative?

NS: Personally, I am the vice chair of our sustainable investing committee, which has huge influence on the business's practices. This is boosted by the great support we have from our operating committee. The committee has helped pull the company's net zero target forward from 2040 to 2030 - a move that has involved thinking about things like business travel, our own real estate portfolio, etc. My view is that we can't have credibility in our investment portfolios if we don't act sustainably in our own operations.

In terms of the mechanics of net zero - do analysts cost potential future regulations individually, or is there a central forecast for carbon prices? Also, where do such considerations manifest - in asset valuations / earnings?

AL: We have no real central forecasts around which base carbon prices and such, but analysts do incorporate things like commodity prices in their forecasts. Nevertheless, portfolio managers often have their own opinions on these things and most of the time the analysts will provide recommendations in consideration of these expectations.

In terms of valuation/earnings impact - this is the big question. The renewable sector had an enormous 2020, mainly on the back of expectations given policy developments and the effects of the pandemic bringing sustainability to the fore. We saw valuations become excessive but subsequently pull back a bit. Now, there is an interesting interplay between earnings and valuations - if companies are able to invest and generate earnings, then they will be able to justify their valuations; but vice versa, if they can't generate earnings their valuations will be undermined.

We have seen large investment by large oil into this space this year, particularly into offshore wind where the UK landbank auction saw far higher prices than were anticipated. This raises the question of whether having such high competition from large oil players reduces the potential for returns and therefore valuations fortraditional players. The answer is yet to be determined.

Alicia, does the current market dynamic mean that bond issues are from companies that are not so green are cheaper and therefore more attractive for investors?

AD: This can be the case - some sustainable issues are indeed more expensive. However, we take a holistic approach to valuations and each case is assessed on its own merits. For example, we take a view of where the capital will end up being spent and if there are non-green companies attempting to transition these canbe attractive, whereas we will not simply buy any green bond just because it is being used for green activities if the price is too high.

How do you evaluate the valuation rollercoaster that accompanies many renewable businesses?

AL: This goes back to the interplay between earnings and valuation. There is a huge amount of capital being deployed in this sector and in many cases what being undertaken exceeds what is needed. An example is Spain, where there is a requirement for around 80GW of renewable energy to replace all their thermal power, but there are currently applications for around 150GW of renewable power generation. This means that there is no economic justification for all this investment, even if the country becomes a massive renewable power exporter. Therein lies the challenge - to identify investments that are going to end up being profitable, given the market dynamics (in particular, the risk of excess supply). Equally, we have the responsibility to try and support the right projects, where investment is meeting real demand at the correct price; under such circumstances valuations can be justified, but we have seen many examples in the past where valuationshave ended up not being justified (e.g. the TMT boom of the early 2000s).

You mentioned that every time the BBC has a report on climate it will have a picture of a power station - are we focusing on this sector too much and are there other areas we should be focusing on?

AD: Definitely. Renewables is the obvious area of focus as it is where power comes from. However, other sectors are also important, as they are also where emissions are generated. For example, having lots of wind farms might be of little use if airplane emissions continue to increase - the overall effect couldstill be negative.

Ned, if all asset managers adopt the same stance, does this mean that passive funds naturally take on the same ethos as active funds?

NS: Engagement is necessary to drive change and passives can't really engage. At Fidelity, we meet with companies 15,000 times a year to foster change - once every ten minutes - and this is something passives can't match. Perhaps indices can be formed around some sustainable variables, but these cannot buildphilosophies and ideals into portfolios.

We've focused on the supply side, but how do you think about the demand side of the equation? If demand for residential / commercial real estate heating and fossil fuel use for transport continue, how do supply side efforts on environmental issues connect with demand on the ground?

NS: There has to be regulatory push and consumer pull. However, these things move in cycles and the bulk of consumer demand shifts occur when economics dictate. Fortunately, the capitalist equation is allowing the economics of environmental sustainability to become more attractive and this will allow the adoption of these solutions to become a no brainer.

AL: If you look at technologies like hydrogen - this has a massive amount of uses to decarbonise other industries - steel production, gas replacement in home heating, in gas turbines, etc. Supply will create use cases if it becomes widely available and this can be pushed by regulation.

Finally, in our recent Analyst Survey we asked whether the COP26 will achieve meaningful progress on climate issues - what are your thoughts on this?

NS: Any opportunity to put pressure on corporates, governments or asset owners is a good thing and I'm very optimistic that COP26 will apply such pressure in a meaningful manner.

AD: I'm also on the optimistic side, particularly given all the renewable investment going on - the world is starting to move in the right direction together.

AL: Single events don't change anything, but continuation does and COP26 will be part of that.

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