

Responsible Investing Perspectives

ESG Viewpoint BMO Responsible Funds and the transition to a low-carbon global economy

Key summary

- The transition to a low-carbon economy is one of the greatest challenges of our times
- The BMO Responsible Funds range is committed to making its contribution to this challenge, and this paper sets out a new, ambitious policy approach
- The Funds will be divesting from all companies with fossil fuel reserves. The Global and Emerging Markets funds are implementing this policy with immediate effect. Our UK funds allow for a transition period, with the full range compliant by 2020.¹
- We will continue to have a strong focus on both investing in companies that offer solutions and on investor engagement, as we aim for the funds to support the transition to a low-carbon global economy.

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¹ The strategies covered by this policy are: Responsible UK Equity Growth Fund, Responsible UK Income Fund, Responsible Sterling Bond Fund, Responsible Global Equity Fund, Responsible Emerging Markets Equity Fund.

Acceleration of the low-carbon transition

The past 18 months have seen a remarkable pace of change in relation to global developments in climate change.

- The 193 members of the United Nations adopted the Sustainable Development Goals, which came into effect in January 2016, and include goals on climate action, as well as related issues including water and clean energy
- The Paris climate change deal, with its commitment to limit global temperature rise to 2 degrees Celsius, came into force in November 2016
- Innovation and scale continue to drive down renewable energy costs and make it increasingly competitive, with new investment in capacity now outpacing that in fossil fuels
- Climate change is increasingly recognized by regulators as a key global risk factor, with the Financial Stability Board commissioning its Task Force on Climate-related Financial Disclosures, which published recommendations for consultation in December 2016
- Confirming scientists' predictions, global temperatures continue to rise, with data from NASA and the National Oceanic and Atmospheric Administration showing that 2016 was the warmest year ever recorded²
- Investor attitudes have continued to shift, with over 700 institutions with \$5.45 trillion in assets having some form of divestment policy in place,³ and an unprecedented scale of investor engagement, including moves to track progress such as the Transition Pathway Initiative

While the political stance of individual countries on the issue of climate change will be subject to the vicissitudes of the electoral cycle—with the U.S., at least at the federal level, retrenching in dramatic fashion—we believe that at a global level, the scientific, technological, economic and social drivers in favor of tackling climate change are unstoppable

BMO Global Asset Management last reviewed our policy in relation to fossil fuels in our Responsible Funds range in 2015. Given the rapid changes that have taken place since then, we have analyzed our approach, with a focus not only on our exclusionary criteria, but more broadly on how the Funds can support the transition to a low-carbon global economy.

The global energy market context

Fossil fuels have underpinned the development of the modern global economy. Cheap, abundant and efficient in their energy conversion properties, they enabled growing prosperity and improved human wellbeing. But over time, the costs of this progress have become more apparent, in terms of risks associated with air quality, safety, social impacts, and most fundamentally, climate change.

Recognizing the overwhelming scientific evidence the Paris climate change deal in 2015, which entered into force in 2016, saw 195 countries agree to an objective of keeping global warming to 'well below' 2 degree Celsius by the end of the 21st century. Achieving this will require transformational change. 81% of current global energy supply comes from fossil fuels; this mix needs to change dramatically in favour of low-carbon sources over the next decades in order to achieve the Paris goals, with substantial new investment in renewable energy sources, as well as in modernized energy storage and distribution. The transition is already well underway, with more global capacity for renewable power now being added each year than coal, gas and oil combined.⁴

Meanwhile, energy demand is set to increase over the coming decades, as the world population continues to grow, and access to electricity expands amongst people in lower-income countries. There has not been a single year in the last 50 where there has been a decline in primary energy demand; growing populations and rising GDP levels will continue to provide two powerful tailwinds to higher energy consumption. Alongside the shift in energy production, energy consumption will therefore also need to be addressed to meet the goals. Energy efficiency measures have the dual benefit of cutting emissions and saving money, and have the potential to stem the growth in global consumption. Energy use per unit of global GDP is already declining—by 1.8% in 2015 alone—but there remains huge untapped potential.⁵

² 'NASA, NOAA Data Show 2016 Warmest Year On Record Globally,' Press release, January 2017.

³ As of April 2017. Source: gofossilfree.org.

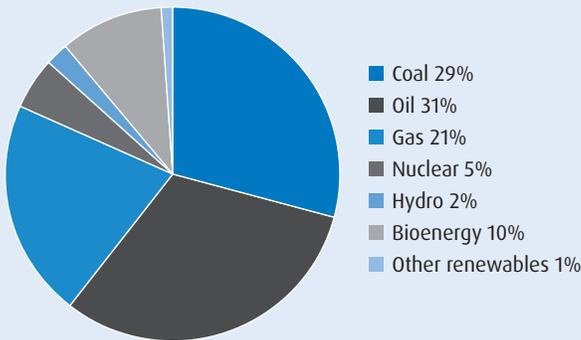
⁴ Renewable Energy: Medium-Term Market Report 2016: Market Analysis and Forecast to 2021, International Energy Agency (2016)

⁵ See, for instance, Energy Efficiency Market Report, International Energy Agency (2016).

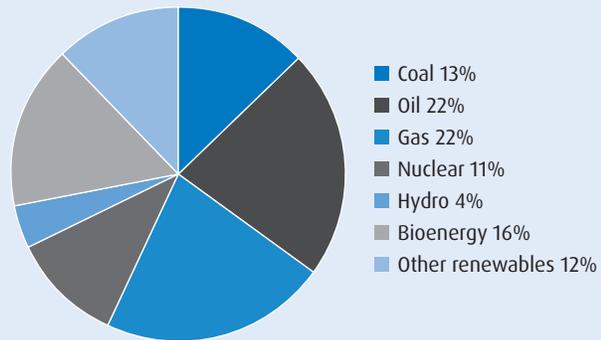
Fossil fuels — is divestment premature?

Despite the changes underway, given the timescales involved in transforming energy infrastructure, it is an unavoidable reality that fossil fuels will remain a part of the energy mix for many years to come. Even under the International Energy Agency’s ambitious 450 Scenario, designed to be consistent with the 2 degrees Celsius goal, fossil fuels will still make up over half of the global energy mix in 2040.

Global total primary energy demand 2014



Global total primary energy demand IEA 2040 450 scenario



Based on IEA data from World Energy Outlook 2016 © OECD/IEA 2016, www.iea.org/statistics, Licence: www.iea.org/t&c; as modified by BMO Global Asset Management.

In this context, a key question is whether divesting from fossil fuels now or in the near future is premature — and in particular, whether there is a risk of undermining economic and human development in developing markets, with over 1 billion people still lacking access to electricity, and 3 billion reliant on polluting fuels such as biomass for cooking and heat.⁶

However, the debate is shifting away from the idea of a simple trade-off between climate change and development, and towards looking at lower-carbon development as a better-quality growth model which is more economically, as well as environmentally, viable in the long term.⁷ Particularly when we take into account the significant subsidies supporting the fossil fuels industry (estimated at up to 6.5% of global GDP⁸), the air quality and health impacts of their use (estimated at up to 10% of GDP in China⁹), and, increasingly, the job and growth opportunities offered by the wave of innovation needed to re-tool the global energy industry, the economic benefits of a greener development model start to add up. This has been recognized by a growing number of the major emerging economies. India, for instance, is targeting 60% electricity capacity from renewables by 2027, and has an ambition to achieve a 100% electric vehicle fleet by 2030; China’s coal consumption has fallen for three consecutive years¹⁰ and it is adding renewable energy sources at a faster pace than coal; the country is on track to peak its overall CO2 emissions between 2025 and 2030.

While fossil fuels will remain part of the mix — with the least-polluting, gas, being an important transition fuel — there is a pressing need to shift the balance of new investment towards the infrastructure needed to support cleaner development pathways, which is where we believe our funds should focus.

⁶ Progress and Information section, Goal 7 (Affordable and Clean Energy), sustainabledevelopment.un.org.

⁷ See in particular *The New Climate Economy* (2014).

⁸ IMF Working Paper 15/105, Coady et al.

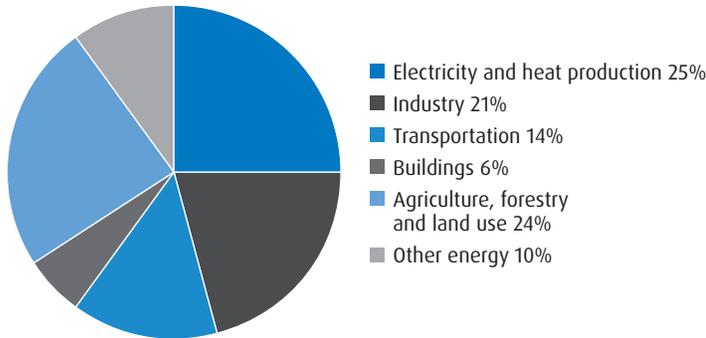
⁹ *New Climate Economy*, 2014.

¹⁰ Statistical Communiqué of the People’s Republic of China.

BMO Responsible Funds policy approach

While the focus of much of the investor debate to date has been on the ownership of companies with fossil fuel reserves (mainly in the extractives sectors), the transition to a low-carbon economy has impacts across many industrial sectors that we as investors may be exposed to, as shown below.

Global Greenhouse Gas Emissions by Economic Sector



Intergovernmental Panel on Climate Change, Fifth Assessment Report (2014).

For responsible funds, constructing a policy on fossil fuels therefore should consider not just extractives companies, but also other key sectors including energy utilities, transportation, buildings, and industrials such as chemicals, cement and steel. Many of these companies are starting to transform themselves, investing in solutions as the growth opportunities present themselves while still supporting legacy products over the transition period. We believe that as investors we should positively encourage these changes.

Critically, therefore, we believe that our approach should consider not just what our funds exclude, but also the opportunities to seek investment in companies providing climate change solutions, as well to engage with investee companies — and policymakers — to promote robust climate change policies.

As the outcome of our previous review, we set criteria in March 2016 which included avoiding companies with the most harmful activities: specifically, the exclusion of companies with over 10% of revenues from thermal coal, and those involved in oil sands¹¹ or drilling in the polar regions or other areas of high environmental sensitivity.

We still believe a nuanced approach is needed, taking into account the complexities of the fossil fuel supply chain and the necessity of a transition process over time. However, as compared with our previous review, we have concluded that a stronger approach particularly in

relation to the extractives industries is justified, and will be excluding companies with ownership of fossil fuel reserves, which we believe are no longer in line with the ethos of the Responsible Funds range. We are also mindful of the potential financial risk associated with ‘stranded assets,’ with the valuation of extractives companies based in part on the future ability to exploit the reserves they own.

Our full climate change policy, shown on the next page, covers the key sectors involved in the production and usage of fossil fuels. Our approach is aligned with our fundamental philosophy for the funds: to **Invest** in companies making a positive contribution to society and the environment, **Avoid** those with damaging or unsustainable business practices, and **Improve** the companies we invest in through using our influence as an investor to encourage best practice management of ESG issues.

From commitment to action

While this policy is new, BMO GAM’s commitment to taking measures around climate change is not. Our extensive work to date relates both to our Responsible Funds range, and to our wider engagement and ownership approach.

Investing in opportunities

Our Funds are already seeking opportunities to positively **invest in companies providing sustainability solutions**, including in the area of climate change. In our Responsible Sterling Bond fund and UK Income fund, this has included investments in green bonds such as those of Enel and FMO, where we apply our own in-house rigorous standards to ensure the credibility of their green credentials. In our Global fund, one focus area has been water — particularly with a concentration on companies involved in infrastructure and water treatment, such as Xylem, as solution providers to the physical impacts of climate change. The fund also invests in industrial gases, such as Praxair, who are focused on improving their customers’ environmental performance while developing innovative technologies using solutions such as hydrogen fuel cells that consume less energy. In the Responsible Emerging Markets strategy, within the Financing the Future theme we are invested in companies providing capital to cleaner energy, such as YES Bank in India which has committed to financing 5GW of renewable energy by 2020.

¹¹ Companies with over 1% of revenues from oil sands are excluded.

Climate change policy

Sector	Criteria
Extractives	<p>The future business growth of companies with reserves of fossil fuels is based on their ability to extract and sell these, mainly for energy production; yet we know that if all current known reserves of coal, oil and gas are exploited,¹² the world could not meet the agreed 2 degrees C temperature limit.¹³</p> <p>It is true that many extractives companies are investing in alternatives, and diversifying themselves into new areas—such as mining companies expanding copper operations, essential for energy efficient technologies, and oil and gas companies scaling up renewable energy investments.</p> <p>But even where extraction of coal, oil or gas may be a falling or relatively small proportion of <u>current</u> revenues, the carbon embedded in the reserves these companies own can still be substantial in terms of its potential <u>future</u> impact on the climate.</p> <p>We therefore believe that companies with ownership stakes in oil, gas or thermal coal reserves are no longer aligned with the ethos of our funds. Therefore, we propose to tighten our existing criteria by excluding these companies.¹⁴ This will take effect immediately for our Global and Emerging Market strategies, and from January , 2020 for the entire range.</p> <p>Service providers to these industries will be assessed on a case-by-case basis, with a focus on whether these companies are supporting more efficient and/or safe operations.</p>
Energy utilities	<p>Energy utilities are key to the energy transition, and in many countries are under increasing regulatory pressure to switch from fossil fuels to alternative sources of energy. Those that take a proactive approach can be part of the solution to climate change.</p> <p>We believe these companies have to be assessed on a case-by-case basis. We will only invest in companies that have comprehensive climate change strategies that seek to measure and control their greenhouse gas emissions, and demonstrate an understanding of the impact of climate change on their business strategy. Specific metrics we will assess include the level of investment in renewable energy technologies; their carbon intensity relative to regional peers; the provision of services to help their customers improve their own energy efficiency; and their transparency and reporting. We will engage companies we choose to invest in, if we see potential for them to further develop their strategies.¹⁵ We will also seek opportunities to invest in alternative energies.</p>
Energy-intensive industries	<p>Examples of energy-intensive industries include chemicals, iron and steel, mining, energy services and paper. These may be heavy users of electricity (and often other resources such as water); use fossil fuels directly; and emit a range of greenhouse gases as a result of their production processes.</p> <p>We assess these companies on a case-by-case basis, looking for emissions management, measurement and reporting, and robust forward-looking energy efficiency strategies. As with utilities, we will engage where we see room for improvement.¹⁶</p>
Transportation	<p>Major emissions sources include road, shipping and aviation, with the largest share coming from road transport.¹⁷ In considering automotive companies and their suppliers the key issue is not their direct emissions, but the energy efficiency of the products they sell and the extent to which they are prepared for the shift towards the electrification of the vehicle fleet. We will look case-by-case at companies in this sector and consider metrics including allocation of R&D and capex budget to carbon-efficient technologies, and engage where appropriate.</p> <p>We will also seek to invest in companies providing more sustainable mobility solutions, such as those involved in fuel efficiency technologies, electrification of the vehicle fleet, as well as in public transportation, such as rail and bus travel.</p>
Buildings	<p>With, typically, an asset life of many decades, changes in the building sector are often slow to come through—but essential to improve economy-wide energy efficiency. Policies in this area are ratcheting up as governments realise the potential for relatively low-cost energy demand reductions. Within this space companies with a focus on smart buildings, insulation, energy-efficient lighting and intelligent controls will play a major part in reducing both emissions and energy demand.</p> <p>We will seek to invest where we see opportunities in companies involved in products and services to make existing buildings more energy-efficient, or building greener new housing, and assess case-by-case companies' sustainability policies.</p>
Agriculture and land use	<p>Accounting for almost 20% of global greenhouse gas emissions, agriculture and land use is one of the most challenging areas to achieve improvements. In agriculture, efficient crop management can achieve higher yields, reducing emissions from tillage and fertilizer use, and we will seek to invest in companies who enable such improvements. However, we will assess case-by-case chemicals companies involved in the manufacture of fertilizers to ensure they have strategies on the greenhouse gas impacts.</p> <p>Major advances have been made in the control of deforestation, particularly in Brazil, but it remains a large source of greenhouse gas emissions as well as a threat to biodiversity. We will assess case-by-case companies in sectors which may be exposed to risk, including food companies that are large users of palm oil, pulp and paper companies, and companies operating in tropical regions.</p>

¹² We do not currently see Carbon Capture and Storage as having the potential to allow this damage to be mitigated.

¹³ See for instance <http://www.nature.com/nclimate/journal/v6/n9/full/nclimate3036.html>.

¹⁴ We define reserves as proved and probable reserves of oil, natural gas or coal.

¹⁵ See US Utilities—Will the energy transition be Trumped?, BMO Global Asset Management (2017).

¹⁶ See 'Viewpoint: Emission Management in Carbon-Intensive Sectors,' BMO Global Asset Management, 2016.

¹⁷ Aviation is a smaller share of total emissions, although research suggests the effects may be amplified through the impact of emissions at altitude. For our UK and Global funds, we currently exclude companies whose primary business is aviation or airports. This exclusion is not in place for our Emerging Markets fund where we believe the extensive safety and air quality issues with road transport give greater justification for investment in aviation.

Using our voice as investors

Our **corporate engagement** has been extensive. We have engaged companies on the topic for over a decade, with an intensification from 2015 onwards as the political momentum accelerated. Our engagement has encompassed all aspects of climate change, including emissions management, energy transition strategies, and adaptation to the physical impacts of climate change, including in land and water use. On the energy transition specifically, we have had focused engagement programs with companies in key sectors, including oil & gas, mining, utilities and industrials.

Our engagement has included:

- Almost 180 one-to-one or joint investor meetings with companies on climate change since 2015, including 45 at Board or senior management level
- Engagement on the energy transition with 58 companies in the oil and gas sector, 15 mining companies, 37 chemicals and materials and 52 power utilities, with automotives a focus for 2017
- Consistent support for shareholder resolutions, filed with energy and materials companies, asking for 2 degree (Celsius) climate scenario resilience testing 76 instances of change recorded at companies

We continue to be a strong supporter of **public policy supporting a low-carbon transition**, with activities in 2016 including a submission to the World Bank on green finance; a joint investor letter to G20 leaders on ratification of the Paris climate deal; and input to the Green Bond Principles. We also contributed our views to the **Financial Stability Board's Task Force on Climate-related Disclosure**, and plan to use this going forward as a key reference point for our engagement with investee companies.

Transparency about our approach

For investors in these strategies, transparency is important to ensure that the ethical approach continues to align with their evolving needs. Our communication includes:

- A **summary criteria** document sets out how our exclusionary screens are implemented
- Regular updates from our **Responsible Investment Advisory Council** highlight changes to these criteria

- For our Global and Emerging Markets strategies, we have published **Impact Reports** which profile the portfolios including analysis of the positive impact through investing in sustainable opportunities
- Our **Responsible Ownership Policy and Corporate Governance guidelines** set out our approach to stewardship, both for these funds and more widely; our **Responsible Investment Annual Report** highlights the outcomes
- In line with the provisional recommendations of the Task Force for asset managers, going forward we will publish **carbon footprints** for our Responsible Funds range on a regular basis

Next steps: Further momentum toward a low-carbon transition

We are committed to continuous monitoring of our ethical and sustainability standards to keep them aligned with emerging issues and market norms, and will continue to watch developments in this and other areas to further develop our approach, using our Governance and Sustainable Investment team, our Responsible Investment Advisory Council and our market networks.

We will also look to respond to client needs in climate change through developing our wider product range. In particular, as well as including green bonds in our Responsible Funds range, we are also already running dedicated green bond mandates for individual clients seeking more focused exposure in this area, and have a Responsible Property Investment strategy for our direct property investments.

More important than anything we do alone is how we act in partnership with others in the investment industry. A coherent, robust investor response to the challenges presented by climate change is only possible if we share experience and work together. Through collaborative groups such as the Institutional Investors Group on Climate Change and Carbon Disclosure Project, through our informal networks and through making our own policies and approach transparent—such as through this paper—we aim to be part of the collective effort to make investors part of the solution to this global challenge.

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