How Safe Is Your Portfolio From The Carbon Bubble

Description

Canada has 173 billion barrels of recoverable oil. This accounts for almost 60% of the world's reserves that are accessible for private investment. Clearly, that's an enormous store of wealth. But what if none of that oil could ever be exploited?

The carbon bubble
What is a bubble? I would argue that a bubble is a massive misallocation of capital based on a faulty assumption. The U.S. housing bubble was based on the assumption that real prices always went up. During the dotcom bubble, investors assumed those early internet startups actually had viable business models.

That's not to say real real estate or technology stocks are bad investments *per se*. But a single wrong assumption caused investors to massively misprice those assets.

A fasinating report (opens to PDF) from CarbonTracker.org asks energy investors to revisit another assumption: what if most of the reserves booked by the world's energy companies could never be exploited?

As we burn fossil fuels, the world is getting warmer. And to avoid the worst impacts of climate change, nations have agreed to limit global warming by two degrees centigrade. To stay under this target, global carbon emission need to remain within a budget of 500 to 900 gigatonnes through 2050.

That's far less than all of the world's currently booked recoverable oil, coal, and gas reserves. Even assuming an optimal rollout of carbon capture technology, most of the reserves held by the world's energy companies would be essentially unburnable.

Today, the global energy industry spends $674 billion annually finding and developing new energy resources. When funding these projects, investors implicitly assume that those new finds will be extracted. But if carbon limits or any other sort of environmental regulations are introduced, less fuel will be consumed and these reserves could become stranded assets that no longer provide a profitable return. This is potentially a massive misallocation of capital based on a faulty assumption.

Is your portfolio safe?

Any effort to mitigate climate change would have a devastating impact on Canada's energy sector.

Take a company like **Suncor** (TSX: SU, NYSE: SU), for example, which is sitting on 6.9 billion barrels of proved and probable reserves. Implicitly, most investors assume that all of those barrels will be extracted. However, these reserves are some of the most carbon intensive on the planet – namely the Alberta oil sands. In a world with a strict carbon emission cap, these reserves are essentially worthless.

Of course, energy shareholders are already aware of regulatory risks. But most Canadian investors would be surprised to learn how much carbon risk exposure they have have hidden within their portfolios.

As another example, take the **iShares S&P/TSX Capped Composite Index Fund** (TSX: XIC). This is the most followed benchmark in the country and probably a fair representation of the average equity portfolio. Notably, almost 25% of the fund's holdings are in the energy sector. The oil patch also has a disproportionate impact on other Canadian industries such as real estate and banks.

Whether you own oil stocks directly, invest in passive index funds, or are enrolled in a pension plan, the average Canadian has essentially made a huge bet on carbon.

What can investors do?
How should investors react to carbon risk? Former U.S. President Al Gore provided a useful set of tips in a *Wall Street Journal* op-ed last week. He advises investors to 1) identify carbon risks across your portfolio; 2) engage corporate boards and executives on plans to mitigate and disclose carbon risks; 3) diversify investments into opportunities poised to benefit from a low-carbon economy; and 4) divest fossil fuel assets entirely.

Jettisoning energy stocks from your portfolio is a hasty action. Especially for Canadian investors with limited alternatives. But just being aware of the carbon risk in your portfolio is an important first step.

Risk isn't a bad thing. It's what we as investors are compensated for. But it's important to understand those risks – be it economic fluctuations, interest rates, or carbon – and price it in appropriately.

Foolish bottom line
Financial history shows that catastrophic losses follow when fundamentally wrong assumptions are made. It might be time to revisit the assumption that all of the booked reserves in the energy industry can be exploited.

This is not an activist crusade for socially responsible investing. Rather, it's a call for shareholders to factor in a real risk hidden within their portfolios.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:SU (Suncor Energy Inc.)
2. TSX:SU (Suncor Energy Inc.)

3. TSX:XIC (iShares Core S&P/TSX Capped Composite Index ETF)

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