Understand Water Risk

Investor Water Toolkit – Tear Sheet

The first comprehensive resource for institutional investors to evaluate and act on water risks in investment portfolios.

www.ceres.org/investorwatertoolkit

The Investor Water Toolkit is the ultimate investor resource on water integration. Developed in collaboration with more than 40 institutional investors from The Investor Water Hub—a working group of Ceres’ Investor Network on Climate Risk and Sustainability—the Toolkit is the first comprehensive resource enabling investors—from pension funds to endowments to asset managers—to evaluate and tackle the water risks in their investment portfolios.

This ‘how-to’ guide includes links to resources, databases, case studies and other tools such as scenario analysis and stress testing. The main elements of the Toolkit are:

- Understand Water Risk
- Establish Priorities
- Buy/Sell Analysis
- Portfolio & Asset Class Analysis
- Water Engagement.

This Tear Sheet summarizes the key steps that investors can take, for each of these elements, to become more water aware in investment decision-making.

U.1 UNDERSTAND THE DRIVERS OF WATER RISK

Research and understand the physical, regulatory and social risks related to water. Water is one of the most critical global risks in terms of both probability and impact, according to the World Economic Forum. Risks arise from growing competition for water between communities, industry and agriculture; lack of climate-ready infrastructure for managing water; linkages between water and power generation; cumulative impacts on water resources from agriculture, land degradation and industrial activities; social license risks and weak government oversight of water in many regions.

U.2 TRANSLATE WATER ISSUES TO MATERIAL RISK

Map the physical, social and regulatory water risks that are potentially most catastrophic and short-term in nature (e.g. loss of social license to operate or large wastewater management risks). Many industries face risks to revenues and future growth related to social license risks where communities, concerned about water competition or contamination, resist further corporate or industry activities. A matrix approach of assessing catastrophic, persistent and relative impact on resources, assets or profitability can be useful in understanding the immediacy and materiality of water risks.

U.3 USE THE INVESTOR WATER RISK DASHBOARD AS A FRAMEWORK TO ASSESS WATER RISK

Understand the three core areas of the water risk dashboard—water dependency, security and response. Map portfolio company water dependency to reveal where water risks lie in the value chain (e.g., sourcing of inputs, wastewater management, direct operations, product use or end-of-life) and water-related financial risks. Assess water-resource security to highlight the physical, regulatory or social license to operate risks a company faces in key regions. Response analysis includes assessing both a company’s resilience to risks and associated strategies to mitigate those risks. To translate water risks to the securities level requires information on these three areas, which interact with each other and either amplify or dampen overall risk exposure.

U.4 ANALYZE SECTOR-SPECIFIC AND GEOGRAPHIC WATER RISKS

Understand where water risks lie for industry-specific value chains. A company’s water dependency and related risks vary greatly by sector. For some industries, such as electric utilities or semiconductor manufacturing, water risks can be obvious as water supplies are vital to companies’ ability to operate. For others, such as food and beverage companies, water risks lurk in agriculture or commodity supply chains. For many industries,
water risks manifest in energy price spikes caused by low water levels or high water temperatures impeding power generation. Water industry analysis is most powerful when combined with geographic analysis that highlights where high-water-need companies are operating in high water risk areas. Several important economic and industrial hot spots have physical, regulatory and social risks related to water.

U.5 ANALYZE PORTFOLIO-LEVEL WATER RISKS

Study water risks beyond the individual security level in order to understand aggregate level exposure to high water risk geographies or industries. For steps on how to do so, see the Portfolio section on the following page.

U.6 ENSURE COMPLIANCE WITH INTERNATIONAL NORMS AND RESPONSIBILITIES

Acknowledge that water use is tied to larger issues of social, community and economic well-being. As water is fundamental for all life, its use comes with responsibilities. Many of these responsibilities are embodied in the U.N.’s Sustainable Development Goal 6, the U.N. Human Right to Water and Sanitation and the U.N. Global Compact.

P.1 ESTABLISH LEADERSHIP COMMITMENT ON WATER ISSUES

Send a strong message that understanding and managing water and other ESG risks and opportunities are a leadership priority by providing guidance from the board of trustees or the highest level of fiduciary authority. Other ways to ensure accountability are through the establishment of dedicated teams such as sustainable investment committees, that are composed of external experts and staff, which report back to the board.

P.2 RESEARCH AND UNDERSTAND MATERIAL WATER ISSUES

Understand the dimensions of water risk and research existing corporate and investor initiatives to improve sustainable water practices. Recognize that water’s role in supporting natural biological, community, and economic systems both creates risks and brings investor responsibilities. Investors should therefore research the full spectrum of water issues and risks before choosing investment priorities or developing policies. Engage investor peers, NGOs, academics, and other stakeholders to expedite background research on investor water issues and help build internal expertise. Many resources are listed in the Toolkit.

P.3 SET PRIORITIES

Set specific, discrete, short and long-term goals. Possible goals could be:

- Improve water risk disclosure (e.g. work with standard-setting organizations and engage companies on water reporting)
- Manage water risks (e.g. include water risks in guidelines for proxy voting and engagement)
- Mitigate water risks and prevent water-resource degradation (encourage companies to understand cumulative impacts of industry on water resources and communities)
- Align with internationally-recognized water standards and norms (such as Sustainable Development Goal 6 or the Human Right to Water and Sanitation)
- Promote positive water impact (e.g. target investments toward improving watershed and infrastructure resilience)

P.4 CREATE A BELIEF STATEMENT AND INVESTMENT POLICIES

Formalize institutional water priorities by creating aligned beliefs statements and/or internal investment policies and guidelines. These can influence fund manager selection, be part of internal compensation structures, and guide proxy voting and engagement strategies, etc.

P.5 TRACK PROGRESS AGAINST KEY PERFORMANCE INDICATORS (KPIs)

Establishing and tracking KPIs related to water and other ESG goals is critical to monitor and encourage progress. KPIs set in motion a cycle of continual improvement and thus can help showcase an investor’s commitment to sustainability or water issues. They can also help build stronger relationships with clients.

B.1 ANALYZE SECTOR RISKS

Study where water risks lie in specific industry value chains. Recognize that a large portion of publicly-listed companies face potentially significant water risks. Research in the Toolkit found that the majority of companies in four major indices—S&P 500, Russell 3000, MSCI World and MSCI Emerging Markets—are in medium or high water risk industries, highlighting the importance of viewing water risks as a broad systemic issue. Industries with particularly high exposure to water risks include: Food Products; Beverages; Household Durables; Construction Materials; Paper and Forest Products; Oil, Gas and Consumable Fuels; Energy
Portfolio & Asset Class Analysis

B.2 USE METRICS AND DATA TO SUPPORT BUY/SELL ANALYSIS

Recognize that no one metric or corporate policy will provide a complete view of water risks. To gain a comprehensive view of water risk exposure, analyze data and information consistent with the Water Risk Dashboard framework, looking at water dependency, security and response. Firms should also take an approach consistent with traditional financial risk analysis, relying on point-in-time metrics, future forecasts and contextual indicators (regional water issues). Many government, NGO, private databases, tools and research resources are available, and the Toolkit provides guidance on when to use what resource.

B.3 USE STRESS-TESTING, SCENARIO ANALYSIS AND IMPACT ASSESSMENT

Apply stress-testing and scenario analysis to gain critical insights into potential future financial impacts of regional water security risks. Study potential water-related tipping points such as over-allocation of existing supplies and regional water quality degradation trends which may cause future high regulatory, physical or social water risks. Recognize that investor-driven corporate water analysis should resemble a dashboard of financial, resource and community impact information.

B.4 WATER DUE DILIGENCE FOR PRIVATE EQUITY DEALS

Use the water due diligence decision tree for new private equity projects. Community concerns and social license risks related to water are the first step in due diligence because these can be the hardest to overcome. Next, analyze physical security of water supplies and steps to mitigate these risks. Finally, assess the water risks and resilience of the project itself. Detailed questions for each due diligence step are in the Toolkit.

B.5 FIXED INCOME: WATER-RISK FRAMEWORK FOR MUNICIPAL WATER AND WASTEWATER

Use the Municipal Bond Cheat Sheet section of the Toolkit as a guide for U.S. municipal bond analysis in the water and wastewater sector. The water risks outlined in this framework include:
- reduced operating efficiencies and higher costs
- unexpected capital outlays for renewal and replacement needs
- unplanned rate hikes that threaten the viability of future projects

Use the framework to engage more deeply with municipal authorities on water and climate issues.

A.1 HEAT-MAP PORTFOLIOS AND PRIORITIZE WATER RISKS

Study water risks at the portfolio level. Even if each of a portfolio’s individual securities has only low or moderate water risk, in aggregate, the portfolio may have high exposure to geographic regions or industries of high water risk. Use the four steps recommended in prioritizing portfolio water risks including:
- Create a heat-map or footprint portfolio water risk
- Conduct an investor influence assessment (e.g. % ownership and ability to influence change)
- Conduct regional risk mitigation analysis, looking at where an investor owns clusters of assets and how mitigating risks in one asset may lower water risks in another
- Identify the holdings that need further water risk analysis, use the Dashboard, stress testing or scenario analysis to assess water risks at the individual security level and assess whether to change buy, sell or hold decisions.

A.2 ANALYZE WATER RISKS ACROSS ASSET CLASSES

Integrate water risk analysis as part of strategic asset allocation decisions. Recognize that many water risks are broad and systemic in nature—e.g. increasing competition for water; increasing water cycle variability (longer, bigger droughts and floods); and the over-reliance in many regions on declining groundwater resources. Map the water vulnerabilities related to particular asset classes (e.g. real estate, agriculture or commodities) and analyze the regions where assets are concentrated to help develop strategies to manage those risks in the region.

E.1 UNDERSTAND THE IMPORTANCE OF INVESTOR ENGAGEMENT

Recognize that proactive engagement on water risks and issues can safeguard investments and align with investment priorities. Strategic engagement activities can tell investors about the quality of management and the ability of companies to manage current and future water risks. Engagement also helps protect the long-term value of assets and can help portfolio company boards and management make better and more informed decisions related to emerging risks such as water.
E.2 BUILD A SUCCESSFUL WATER ENGAGEMENT STRATEGY

Consider taking these four steps to build a water engagement strategy:

1) Research which water risks are most critical, and in line with institutional goals, and establish effective engagement tactics such as investor statements of public expectation, collaborative engagements and shareholder resolutions
2) Develop time-bound performance indicators to track engagement progress
3) Publish corporate water management expectations
4) Embed water in proxy voting guidelines

E.3 USE THE WATER RISK DASHBOARD IN ENGAGEMENT

The Water Risk Dashboard outlines the importance of collecting information on corporate water dependency, water security and response. Ask management the following questions addressing:

- Dependency: “What do you do?” Where do water risks lie in your value chain? From supply chain to end of product lifecycle?
- Security: “Where do you do it?” What are the regions of concern and what water risks are most relevant or material?
- Response: “What are you doing about it?” What is the company’s response to these risks? And how much might the company lose due to water risks?

E.4 CONSIDER COLLABORATIVE ENGAGEMENT

Get involved in collaborative engagement initiatives with other investors. Investor networks have water working groups, focused on deepening understanding of material issues and on collaboratively engaging companies. They include networks such as Ceres’ Investor Water Hub and Shareholder Initiative on Climate and Sustainability (SICS) groups, PRI’s Water Risk Engagement group and ICCR’s Water working group.

E.5 FILE SHAREHOLDER RESOLUTIONS AND VOTE YOUR PROXIES

Over the past 10 years, investors have filed hundreds of resolutions on water. Many have led to successful negotiations with companies on issues including water-risk disclosure; supply chain resiliency; the human right to water; and water pollution concerns. Proxy voting guidelines provide clear direction on how fiduciaries should vote on key ESG issues, including water. Ceres has pulled proxy voting guidelines from nearly 50 institutions with water-related language. Proxy-voting guidance should be revised annually or semi-annually to improve engagement protocols, account for the latest market risks and help steer companies towards better water stewardship. Investors can use the guidelines to engage third-party proxy voting services such as ISS and Glass Lewis on best-in-class voting recommendations.

E.6 DRIVE SYSTEMS CHANGE

Engage standard-setting organizations on ways to improve disclosure and risk management of ESG and water issues. Institutions that have been engaged include:

- Financial regulators and standard-setting bodies (e.g., the Securities and Exchange Commission in the U.S.)
- Finance industry associations (e.g., CFA Institute)
- World Federation of Exchanges and regional stock exchanges
- Industry organizations (e.g., food and beverage, mining, apparel, oil and gas)
- Disclosure bodies (e.g., International Integrated Reporting Council, CDP, Global Reporting Initiative, Sustainability Accounting Standards Board)

E.7 TRACK ENGAGEMENT PROGRESS

A number of investors benchmark engagement progress over time, outlining goals and expectations for engagements to ensure that critical water-related outcomes improve over time. For example, ICCR has created a useful hierarchy of engagement impact with eight indicators of progress:

1) Company acknowledges issue
2) Company adopts policy
3) Company creates goals/plans
4) Company develops metrics
5) Company benchmarks progress against its peers
6) Company conducts independent verification of its data
7) Company demonstrates positive impact
8) Real progress on issue or risk

For more information see www.ceres.org/investorwatertoolkit

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