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THINKSPACE

PERSPECTIVES ON

The Future of Sustainability — In Practice

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This article presents takeaways from a session at GIC Insights LIVE 2020, where panellists Jeremy Grantham, Co-Founder of GMO, Bob Litterman, Chairman of the Risk Committee at Kepos Capital, Debbie McCoy, Head of Sustainable Investing at BlackRock's Systematic Division, and Jaap van Dam, Principal Director Investment Strategy for PGGM, discussed how investors are integrating sustainability considerations into their investment frameworks, strategies and processes, while also navigating associated challenges.

***GIC Insights** is our annual flagship event that gathers a select group of prominent business leaders to deliberate over long-term issues pertinent to the international business and investment community.*

There are profound underlying threats to the long-term survivability of our species and civilisation, including "unlivable" climate conditions affecting a significant share of the world's population, loss of global food production capacity, declining populations in the developed world due to below-replacement fertility rates, as well as growing inequality, distrust and divided government responses to global crises.

At the same time, technology is enabling great advancements. There is also a higher degree of awareness, transparency and sense of shared community that presents opportunities to address these issues. The investment world can contribute positively to collective action for better outcomes.

> **ON ONE HAND, THE CLIMATE IS CLEARLY DETERIORATING DESPITE OUR BEST EFFORTS. WE ARE IN THAT SENSE, RACING TOWARDS THE CLIFF EDGE. BUT ON THE OTHER HAND, THE TECHNOLOGY, PARTICULARLY IN AMERICA, IS MAKING INCREDIBLE PROGRESS.**
>
> ***Jeremy Grantham***
> ***Co-Founder, GMO***

A poll of session attendees showed that 43.6% of respondents do not believe there is a trade-off between sustainability outcomes and investment returns, 35.5% believe there is a trade-off, with the remainder uncertain.

Panellists acknowledged the complexities of this issue and encouraged a more nuanced approach that goes beyond choosing either returns or sustainability. While returns and sustainability often go hand-in-hand, this is by no means a law of nature. Often, many factors have to coincide in order to realise better returns per unit of risk taken. For example, laws and regulations, technological development and consumer behaviour. This belief in a positive outcome should therefore never be mechanically applied.

An alternative way to view this issue is through a matrix which outlines areas where sustainability and returns will go hand-in-hand as well as areas where they conflict. This will help investors to understand, by topic or asset class, the right actions to take for the relevant investment horizon.

The starting point is key — if investors begin with the assumption that a sustainability factor will not have a return implication, the "trade-off" quandary cannot be resolved. Instead, it would be meaningful to start by quantifying what sustainability is and applying this to the early part of the portfolio building and analysis process, rather than making modifications based on sustainability considerations at the later stages.

It is also important to consider the potential for investors to transform society by engaging sustainably. If investors can be ahead of the curve, they stand to benefit both in terms of doing good and performing well financially, at the same time supporting the transition to a more sustainable society.

LESSONS FROM RISK MANAGEMENT

There are valuable lessons from risk management that can be applied to the response to climate change.

- Risk management requires consideration of the full distribution of potential outcomes, including worst-case scenarios. Similarly, it is essential to consider the extreme but plausible scenarios that could result from climate change, as these could be catastrophic if realised.
- Time is a scarce resource in managing risk, as well as in responding to climate change — where time is running out, yet issues have not been fully addressed.
- The purpose of risk management is not to minimise risk, but to ensure appropriate compensation for the risk taken. In the area of climate change, the fundamental flaw is that risk today is not adequately priced. Taking into account risk and the worst-case scenarios would imply a higher price today, rather than the traditional notion that price should be low today and rise slowly over time to a higher price in the distant future.
- Economists often make a distinction between risk and uncertainty. Risks are the model-based metrics that we create, while uncertainty is what we manage in the real world. There is great uncertainty around potential outcomes relating to climate change. Erring on the side of caution is necessary.

The belief is that applying these lessons, and pricing risk, will reveal an inevitable higher price on emissions, which will result in a dramatic phase change in all areas of the economy. Investors should be prepared for this.

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TO GET TO NET-ZERO BY 2050 IS GOING TO BE A VERY RAPID TRANSITION. IT WILL HAPPEN. WE WILL PRICE EMISSIONS GLOBALLY IN A HARMONISED WAY, AND THAT WILL CREATE DIFFERENT INCENTIVES AND AFFECT THE PROFITABILITY AND VALUATIONS OF ALL ASSETS AROUND THE WORLD. WHEN IT WILL HAPPEN IS HARD TO SAY, AND SO THERE IS RISK.

Bob Litterman
Chairman of the Risk Committee, Kepos Capital

PUTTING SUSTAINABILITY INTO INVESTMENT PRACTICE

Drawing from their extensive experience in sustainable investing, the panel shared ways in which sustainability can be applied to investment practice effectively:

- Investors should formulate clear, long-horizon strategic goals that incorporate sustainability. Conversely, adding sustainability as an incremental layer to existing investment practices often leads to sub-optimal results and to greenwashing, which will not stand the test of time.
- With the significant amount of data and information available, investors should apply advanced analytics to an expanded set of data to inform portfolios. This can help investors better understand and capture the interaction between societies, companies and returns, and also incorporate traditionally understudied areas. Examples of how this has been applied include using geospatial images after climate disasters to understand economic restarts, and human

development data to understand the impact of diseases on populations.

WE ARE ABLE TO USE SOPHISTICATED PROCESSING TOOLS TO CONSUME INFORMATION ABOUT THE WORLD AROUND US AND EXPAND THE REALM OF WHAT WE ARE ABLE TO LOOK AT. WE THINK THAT IS REQUIRED TO TAKE INTO ACCOUNT THE HUMAN EXPERIENCE, TO TAKE INTO ACCOUNT THE PHYSICAL WORLD, AND FIGURE OUT WHAT WILL MAKE OUR PORTFOLIOS RESILIENT, AND ALSO THE WORLD AROUND US MORE RESILIENT.

Debbie McCoy
Head of Sustainable Investing, BlackRock Systematic Division, BlackRock

- Alpha or beta? Seeing sustainability as a source of short-term alpha can lead to disappointments, as companies and economies are on the whole expected to move in a more sustainable direction over time. On the other hand, applying a “better beta” lens will ensure a well-constructed, future-proof portfolio that is likely to generate better, more resilient returns over the long run.

- Exclusion is not the most productive way to run a portfolio. Investors should leverage the range of instruments at their disposal to generate better returns per unit of risk and influence positive outcomes. One example is going short in areas that are expected to underperform. Having a clear view of what sectors and companies will do well, and constructing a portfolio based on these views is key.

INVESTMENT OPPORTUNITIES

Attractive opportunities exist in the general area of carbon-related assets that seek to reduce emissions, which are trading cheaply. For example, carbon allowances around the world, which have the potential for appreciation. Fundamentally, every tonne of carbon dioxide that goes into the atmosphere today is very likely going to have to be pulled out of the atmosphere at some point in the future, and this will involve paying those who are willing to do this.

Other promising areas include the bio-engineering of microbes to produce energy to sequester carbon and to create protein, food and new materials, as well as the fusion companies that are showing steady progress towards commercially useful products.

There is also a larger opportunity for investors to influence outcomes through investment decisions. This requires a mindset shift away from the traditional belief that investors are exogenous to outcomes of the world, and towards recognising that allocation of capital thoughtfully, and in the right direction, can make a positive difference in solving fundamental sustainability issues.

IF YOU ALLOCATE YOUR SCARCE PRODUCTIVE CAPITAL IN THE WRONG WAY, YOU WILL PRODUCE WASTE. NOT ONLY WASTE FOR YOU AS AN INVESTOR AND YOUR BENEFICIARIES, BUT ALSO WASTE TO SOCIETY AS A WHOLE. LET’S RECOGNISE THE ROLE WE PLAY IN ALLOCATING THE SCARCE CAPITAL OF THIS WORLD, IN THE RIGHT DIRECTION

Jaap van Dam
Principal Director Investment Strategy, PGGM

SETTING ORGANIZATIONS UP FOR SUCCESS

Sustainability is a long-term journey with multiple stages of maturity. Panellists offered guidance on how to bring organizations, that are made up of individuals with differing viewpoints, on this journey.

- Produce research and insights that can be used to inform and support robust portfolios built around sustainable investing. At the same time, offer options to stakeholders, to demonstrate the implications of potentially investing in a different way.

- Set the right tone at the top. Sustainable investing requires a long-term horizon, and having the board and management look beyond traditional short-term objectives and articulate strong investment beliefs around sustainability sets the organization on the right path towards success.

- Build on-the-ground commitment, not compliance. This could mean starting with small steps in areas that have the potential to create attention without jeopardising overall results, then cascading knowledge and experience to other teams. This could also mean hiring differently, if needed.

- Create diverse teams. Place those who are closer to the subject — for example, young people — in positions of power where they can build mandates, make decisions and integrate sustainability effectively. Investment professionals also need to be not just finance-educated, but also well-versed in their understanding of sustainability.