Sustainability

Challenges and Opportunities

- At a time when climate change and energy security dominate the global discourse, most investors would agree that environmental, social, and governance (ESG) considerations play a critical role in investment decisions.
- However, it turns out that “if” is not the most important question when it comes to sustainable investing. It’s “how”.
- Investors have access to a slew of third-party sustainability data and ratings, and companies are increasingly vocal about touting their sustainability targets and credentials. Still, putting that information into its proper context and determining how it colors the overall investment picture is a complex, nuanced task. Disclosures are not standardized, making it difficult to compare companies to their peers.

One of the most powerful concepts in economics and finance is that doing nothing is not the same as staying neutral. In fact, it comes with a price tag: opportunity cost, which means the forgone potential benefit of doing something. Over the past year, the opportunity cost of staying neutral on some of the most pressing global issues has become quite clear.

In the run-up to the COP26 climate conference in Glasgow, scores of companies announced net-zero emissions targets, pledging to reduce carbon emissions (and to offset whatever they could not eliminate) such that in total, the amount of greenhouse gases they added to the atmosphere was consistent with limiting global warming to 1.5° Celsius (Exhibit 2.0.1).

Exhibit 2.0.1
How Widespread Are Net-Zero Pledges?

70	1,000+	1,391	1,000+	400+
Countries	Cities	Companies	Educational Institutions	Financial Institutions

Source: United Nations
As of 8 April 2022

Investors who failed to fully grasp what these targets would mean not only for cost structures, but also for how proactively a company was positioning for a climate-conscious future, would clearly be at a disadvantage. With the announcement of the Glasgow Financial Alliance for Net Zero, representing 450 global institutions and $130 trillion in assets under management, it was also quite clear that stewards of private capital are increasingly expected to use their power to have a positive influence on the planet.

Meanwhile, the war in Ukraine shone a spotlight on the security risks that can be associated with a global dependence on fossil fuels. Europe, in particular, encountered a poignant dilemma: In order to stand up to Russia, it had to face the prospect of losing access to Russia's oil and gas. Until new infrastructure can be built, asking residents to turn down their thermostats in the coming winter is among the serious options on the table. The war also showed what can happen when the global food supply is threatened. Soaring prices for wheat and other food commodities that Russia and Ukraine produce in abundance are nudging food prices higher everywhere, but particularly in some of the world's poorest places.

In an environment like this, the decisions companies and sovereign bond issuers make in regards to the fuels they use, their overall emissions, and the products and services they offer can have material consequences for the valuation applied by a diligent investor. Indeed, given the rise in commitments to sustainable investing funds, investors seem to realize that environmental issues, as well as social and governance issues, truly do present material risks and opportunities for their portfolios (Exhibit 2.0.2). But that diligent investor has an increasingly difficult job to do in sorting out the potential for future regulatory action, the costs and potential revenue streams associated with a company's future plans, and even separating serious planning from hype.

While we have focused so far on the global risks of climate change, and specifically, the use of fossil fuels, there are many other ESG issues that present material risks to investment portfolios. Overuse of scarce natural resources such as water can threaten a business model just as surely as an ecosystem or community, for example, while compensating employees well can put companies at a competitive advantage in attracting talent and reducing turnover.

Exhibit 2.0.2

Global Sustainable Investing Assets

Snapshot of Global Sustainable Investing Assets ($, b)

Region	2016	2018	2020
Europe	12,040	14,075	12,017
United States	8,723	11,995	17,081
Canada	1,086	1,699	2,423
Australasia	516	734	906
Japan	474	2,180	2,874
Total	**22,839**	**30,683**	**35,301**

Global sustainable investment at

$35.3 trillion

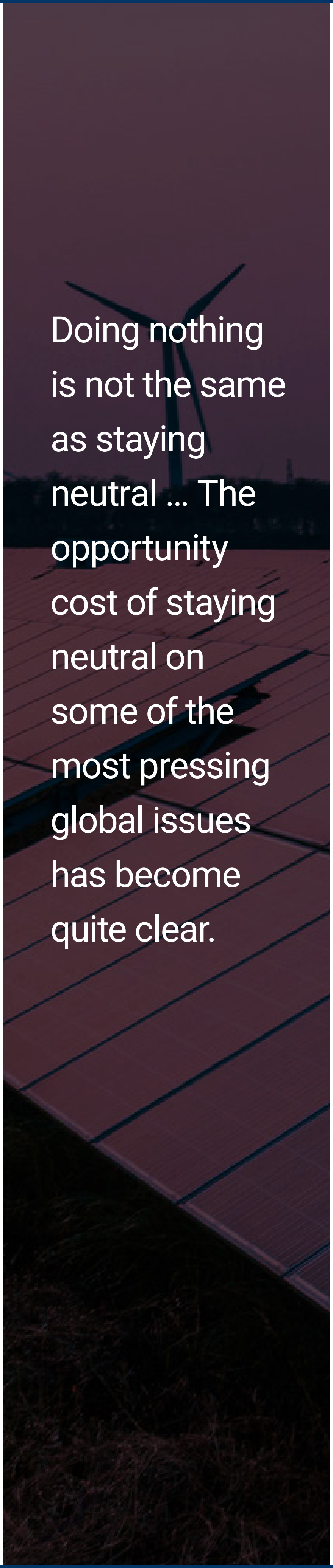
Snapshot of Global Assets Under Management ($, b)

	2016	2018	2020
Total AUM of Regions	81,948	91,828	98,416
Total Sustainable Investments Only AUM	22,872	30,683	35,301
% Sustainable Investments	28.0	33.4	35.9
Increase of Sustainable Investments over Prior Period (%)		**5.5%**	**3.0%**

35.9%

of total assets under management are sustainable investments

Source: Global Sustainable Investment Alliance
As of 19 July 2021



Though the list of potential risks and opportunities from ESG factors is endless, we choose to focus for now on the very timely issue of climate change, specifically energy and the use of fossil fuels. We start by examining in greater depth the current push for decarbonization, from how it can be achieved to what cutting emissions might mean for corporate valuations. It will also address why even amid a growing pile of available third-party metrics and ratings, deep, independent fundamental research can be an enormous asset in making sustainable investment decisions.