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Investing for a world of change

Sustainable investing needs to evolve. Fast

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The fast view

- The business world is changing – sustainable investment approaches must adapt to keep up.
- Asset managers need to invest in developing new skillsets, better analytical tools, and valuation methodologies that can price the full spectrum of externalities.

New approaches

Sustainable investing has been the subject of fierce debate recently. But rather than arguing about how well it has worked in the past, it would surely be more useful to figure out what kind of investment approaches we need now – and that starts with taking a view on what the future looks like.

An obvious thing to say is that the future looks pretty terrifying unless we get better at allocating capital to tackling climate change and other pressing sustainability concerns. Annual climate finance needs to increase almost six-fold, according to the Climate Policy Initiative, to limit global warming to 1.5C. And, crucially, this capital needs to go to the right places. Today, around 80% of the world's financial assets are located in developed markets, but we know that at least 70% of the investment required to achieve the Paris Agreement climate targets and the UN's Sustainable Development Goals must be directed to emerging markets. The net-zero transition, and sustainable development more broadly, remain woefully underfunded in the developing world.

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Good eggs, bad eggs

This is unlikely to change with today's sustainable-investment approaches, many of which essentially involve giving companies an ESG (environmental, social & governance) score and dividing them into good eggs and bad eggs for portfolio inclusion or exclusion. Often, emerging market companies end up in the bad-egg pile because their scores tend to be lower than those of their developed market counterparts.

Firstly, this gives no consideration to a company's willingness or ability to drive sustainable development where it is desperately needed, including with respect to climate solutions, financial inclusion, physical and digital infrastructure, healthcare and education. Secondly, it ignores emerging companies' potential to deliver growth and profits for the benefit of shareholders. Many in the West fail to appreciate that being a leader in sustainability can be a growth tailwind for these businesses, too. Surveys show that developing-world consumers also care about biodiversity and nature loss. The Chinese, in fact, are even more willing to buy electric vehicles than Germans.

So the first item on the to-do list is to evolve today's simplistic and backwards-looking sustainability assessments into more intelligent, contextualised appraisals. This way, the babies will not be thrown out with the bathwater and emerging markets will be properly represented in sustainable portfolios.

Understanding externalities

Next, we need to adapt the way we invest to reflect changes in the business world. Perhaps the most significant of these is that companies are increasingly being held to account for their externalities – i.e. their impacts on the environment, society and individuals.

The traditional way of thinking about shareholder returns is that they are generated at the expense of other stakeholders. Today, we see evidence that consumers, society and markets are starting to reward companies that consider the impact they have on all stakeholders, and in so doing create value for all. As a simple illustration, some 80% of consumers now think about the environment when making technology purchases, according to a Ninety One survey, suggesting a strengthening link between consumer-goods companies' environmental impacts and sales. Meanwhile, a recent MIT study found that corporate culture was by far the biggest determinant of talent lost during the Great Resignation. In other words, companies' impacts on the day-to-day lives of employees matter more to their ability to hold onto the best and brightest than how much they pay.

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'Good egg/bad egg' sustainable-investing approaches are not equipped to value these externalities – i.e., to calculate the returns generated on the natural-, social- and human-capital companies deploy. So we can add 'develop externality-valuation tools' to the to-do list.

This trend towards the internalisation of corporate externalities – an overblown way of saying that companies' chickens will increasingly come home to roost – is happening to a far greater extent than many people seem to realise. To get ahead of this shift in how the world appraises companies, investment managers are likely to have to expand the skillsets and cognitive diversity of their teams. If the companies of tomorrow succeed because they act and think differently to their predecessors, it seems a fair bet that the successful investment teams of the future will look and behave differently to those of today.

New metrics and methodologies

At this point, you may be hearing hoots from traditional portfolio managers, who will say that we are merely confirming what they have argued all along: that ESG has always been a sideshow, and that they have always invested sustainably in the sense that their valuations have accounted for any factor that may influence a company's financial return, including externalities.

But how? Details on companies' carbon emissions has only been collected relatively recently. And that's at the data-rich end of the sustainability spectrum. There is a paucity of metrics and methodologies that enable portfolio managers to calculate the value of the environmental-capital companies create or destroy through externalities that impact biodiversity, land, water and air quality. Ditto estimating the social-capital value of companies' impacts on communities, and the changes in employees' aggregate human-capital value caused by their workplace practices. We know this because my colleagues and I have had to develop them ourselves.

You may be thinking that ESG data-providers collect information on all this stuff. They certainly collect myriad datapoints. But what does the percentage of women holding board seats or executive roles really tell you about a company's future growth and profitability?

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More sophisticated assessments

These oft-cited diversity metrics offer a neat illustration of where sustainable investing is today, and where it needs to get to. By itself, diversity will not make a company more innovative and responsive to customers' needs. These drivers of growth will only be unlocked if the company is run in a way that enables people from all walks of life to contribute and exert influence. Is the company a melting pot, or just a salad bowl? To answer this, the analyst needs to appraise not only a company's diversity, but its inclusiveness. This is a more complicated, qualitative assessment that requires in-depth, direct knowledge of a company.

Who possesses the latter? Portfolio managers. The final to-do, then, is for them (and the more diverse and inclusive investment teams that will hopefully succeed them) to fully incorporate these new methodologies for valuing externalities into their fundamental analysis, rather than relying on external ESG ratings and other outsourced sustainability insights.

So there's no need to throw sustainable investing onto the junk pile of bad ideas. In some ways it is coming home, to the heart of the investment process. And it isn't broken. It just needs to evolve towards new skillsets, better analytical tools, and valuation methodologies that can price the full spectrum of externalities.

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