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ARE RISK-ADJUSTED RETURNS WITH A POSITIVE IMPACT DESIRABLE AND ACHIEVABLE?

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Ongoing media coverage of greenwashing has generated a great deal of skepticism regarding sustainable, or impact investing. In its June special, the Economist proclaimed the acronym "ESG", stood for 'Exaggerated Superficial Guff' and warned that three letters 'won't save the planet'. It went even further to say sustainable investing and 'woke capitalism' are duping investors into substandard returns. With the controversy running hot, it is perhaps a good moment to revisit the question, 'Are risk-adjusted returns with a positive impact desirable and achievable?'

A CHANGING CONTEXT

Over the last three decades, the context for capitalism has been shaped by a deep recognition of the interconnectivity between the biophysical, social & market systems. This systems view is built on global scientific consensus, social necessity, and economic reality. Notably, after the global financial crisis the Financial Stability Board (FSB) was established to assess both endogenous market risk (i.e. the risks that emanated from within the markets such as the sub-prime crisis) and exogenous market risk (i.e. risk that stems from outside the market system, such as climate change). The scale of climate risk resulted in the FSB overseeing the publication of the Task Force on Climate-Related[1] Financial Disclosures and called for climate stress-testing by central and large, systemically important banks[2]. As the concept of exogenous risk has become more widely understood, market regulators have moved to encourage the market system to proactively address long-term risks to sustainable development. For example, the EU Green Economy Taxonomy[3] sets out which economic activities are aligned with low carbon, resource-efficient and socially inclusive outcomes. To increase alignment, the EU has adopted corporate sustainability reporting[4] standards (CSRD), disclosure standards for financial products' sustainability attributes[5] (SFRD) and is ensuring through Mifid II that client sustainability preferences and risk are used as a basis for ensuring product suitability[6].

For business leaders this shifting context means that remaining competitive will require effective human capital management, sound pollution controls, resource efficiency, and products and services that address social / ecological issues. For publicly listed companies the requirements for sustainability style disclosures have increased on all major stock exchanges as investors recognise that poor environmental, social and governance practices can, and do, detract from returns.

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Viewed rationally the current context for capitalism requires investors to consider how well their portfolio is positioned with respect to long run risks associated with social and ecological system stability. Viewing a portfolio through a 'sustainability lens' is simply good investment practice and aligns with capital preservation and growth objectives.

As the transition to a 'green economy' gathers momentum, there will be winners and losers across regions, sectors and asset classes, and it would be a mistake to think that all 'green' or impactful investments will generate appropriate risk adjusted returns. As such, while it may be desirable to focus on impact outcomes, achieving success in this changing context will require a nuanced approach.

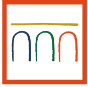
A TACTICAL RESPONSE

The rapid growth in the scale & availability of ESG/impact & sustainability data is propelling the market towards a deeper understanding of the trade-offs across risk, return and impact. Impact can be understood as both harm reduction (i.e. reducing pollution), as well as net positive contributions from goods and services (i,e, access generic medicines in emerging markets).

On a pragmatic level, it makes sense for investors to consider the transition of their portfolios in a manner that achieves a like-for-like risk/return outcome with a measurably enhanced impact outcome. This will require trade-offs across asset classes, sectors and geographic exposures over time. Consider for example that public markets offer liquidity and scale but less direct impact, while private markets offer real world impact, but are constrained in terms of capital deployment and liquidity. From a geographic perspective, emerging market exposure is seen to offer greater levels of impact per unit of return than a similar sector allocation in developed markets.

This is an evolving space, driven by scientific necessity, changing policy, shifting consumer sentiment and economic competitiveness. It would be a mistake to view it as a fashionable trend whose time has passed. Greenwashing risk does exist. However, the long-term "green" transition is underway and pragmatically aligning investor portfolios with risk, return and impact outcomes is both desirable and achievable.

[1] Task Force on Climate-Related Financial Disclosures | TCFD) (fsb-tcfd.org)
[2] Testing for climate goal alignment (admin.ch)
[3] EU taxonomy for sustainable activities | European Commission (europa.eu)
[4] Corporate sustainability reporting | European Commission (europa.eu)
[5] Sustainability-related disclosure in the financial services sector | European Commission (europa.eu)
[6] Sustainable finance – obligation on investment funds to advise clients on social & environmental aspects (europa.eu)



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