Climate Change Investing: Our Responsibility & Opportunity

"Companies that don't adapt will go bankrupt without question."

Mark Carney, Bank of England Governor, July 31, 2019

Climate change is transforming financial markets. Scientific and economic research consistently states that climate change, if left unchecked, will result in hundreds of billions of dollars of losses per year by the second half of the century. Efforts to mitigate and adapt will be necessary in order to avoid the worst and possibly catastrophic consequences resulting from rising global temperatures. Financial markets are exposed to both physical and transition risks. Physical risks result from the rise in extreme weather events, made worse by rising global temperatures. Such risks include extreme flooding, droughts, excessive heat, rising sea levels and more severe storms. Transition risks include potential economic losses due to changes in policies and technology as businesses and governments enact laws and change behaviors to lower emissions.

Looking beyond the financial market impacts, achieving sustainability means tackling a broad set of interconnected systemic challenges, including public heath, racial justice and climate change. We know that climate change has a broader societal impact, as the consequences of extreme weather events is expected to have a disproportionate impact on the impoverished and people of color. Projections of population growth, particularly in Africa, will only exacerbate the crisis. We believe that the events of the second quarter 2020 have raised awareness among businesses that concepts like resiliency and justice are not simply desirable social outcomes. Rather, these social and environmental considerations will be more relevant in the way companies operate their businesses and articulate their brands.

Market participants have started to react. Corporate shareholders and investor advocacy groups are demanding action. An increasing number of companies are evolving their social and environmental practices and changing their businesses. And while skeptics might refer to these practices as greenwashing, a growing body of research suggests that companies that operate and deliver products or services in a sustainable manner will reap the benefits through a more productive workforce, customer loyalty and reduced costs. These trends are supported by demographics research that suggest consumers and potential employees, especially millennials and Generation Z, will consider a company's sustainability practices as a criterion for whether or not to engage with that company.

Concurrently, a growing number of investors have adopted practices that in one form or another build and maintain portfolios based on social and environmental factors. For example, some investors have chosen to divest from fossil fuels, seeking to align their investments with their organizational beliefs, values or mission. Others have adopted broad ESG strategies that are based on company performance ratings across various environmental, social and governance factors. In 2013, 15% of public institutional investors incorporated ESG factors into decision making. Today, 49% of public funds are doing so. Still others have sought to use their investments to make a positive impact on climate change mitigation through active shareholder engagement and/or commitments to invest in climate solutions such as clean energy.

Answering the question "what to do?" is complex. For many investors, adapting an investment strategy to account for the risks associated with climate change strategies is new territory. Investors must sort through a myriad of challenges to satisfy their performance objectives, comply with fiduciary duties, while also trying to implement sustainable investment principles. Even for investors who have adopted ESG or SRI principles, challenges exist because those approaches for the most part only address climate change at the margin, through small adjustments to the weightings of individual stocks and sectors that don't materially change a portfolio's climate value at risk.

In addition to the risks, climate change also presents opportunities for investors to position their portfolios to capture returns. We're seeing these opportunities manifest themselves as part of the energy transition, where technological and behavioral trends support clean energy over fossil fuels. The price of renewable energy has plummeted over the past decade and will keep doing so as green technology continues to make revolutionary advancements. Solar and onshore wind are now the cheapest form of new energy generation for two-thirds of the world even in the face of low oil and natural gas prices.

More broadly, we expect innovation to occur and new companies to emerge that will help to protect society against the physical impacts from climate change. For example, these companies could be involved in sea wall construction or other infrastructure (to protect against sea level rise, extreme storms and flooding), housing and other requirements for expected climate refugees, and water resources or purification. While many of those opportunities may currently lie in privately held companies, as those industries mature (much like the clean energy sector has), investors will likely be able to gain exposure through a deeper universe of publicly traded companies.

Choosing the appropriate climate investment strategy is dependent on an investor's objectives and constraints as are decisions to divest, engage, manage risk, seek returns, and generate impact. That said, we believe the risks and opportunities posed by climate change to the financial markets are multi-dimensional, and that conventional investment approaches used by most investors to allocate capital and select asset managers are not suited to delivering desired results. As such, the solutions that we are creating are grounded in the following core principles:

Portfolios incorporating macro trends can complement existing allocations: As a macroeconomic trend, climate change will affect the traditional industrial sectors unevenly and, in some cases, with severe financial consequences. We expect that the addition of thematic strategies, designed to purposefully achieve direct economic exposures to the low-carbon economy will enhance the performance profile of portfolios constructed primarily using benchmark driven market-return objectives. Benchmarked strategies (whose performance is measured versus a broad market index) have a greater potential to hold sectors such as traditional energy that are adversely affected by climate change transition risk. Our view is that most long-term investors who believe that the transition to a low-carbon economy is inevitable should have an allocation to a macro-driven climate strategy as a complement to their broad market allocations.

Factor-based approaches are efficient for sourcing alpha. Blending proprietary sector research with best-of-breed factor-based analytics and technology turns data into actionable information critical to security selection. Industries and their constituent companies are confronting differing levels of risks and opportunities from climate change. Today's financial reporting regimes may not adequately disclose or describe such information. Factor-based methods permit the efficient analysis of such climate data. Its integration with fundamental business and financial information provides actionable intelligence vital to better security selection. We believe that factor-based analysis combined with algorithmic monitors of the overall market environment will become the dominant mechanism through which managers can generate value for their investors.

Conventional solutions are likely to yield conventional results. Traditional models of selecting funds or pre-baked strategies are sub-optimal for investors with multi-dimensional objectives to allocate capital. Conventional thinking suggests that hedge funds and index funds are not naturally compatible. Combining the best elements of both can produce solutions that are ideally suited to long-term thematic investors seeking to manage the risks and opportunities associated with climate change. Our view is that thematic strategies constructed using a hybrid portfolio management model that combines the flexibility of hedge funds to take macro positions and the tools of indexed/factor-based funds for security selection is the most efficient and cost-effective way of producing alpha for investors.

It is our belief that the creative and thoughtful construction of portfolios will allow investors to align their sustainability principles with performance objectives. Transparently investing for performance, people, purpose and the planet should become the norm, rather than the exception.