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Investing in climate

The financial community is often criticised for seeking quick returns. How do we encourage private finance for climate action when the pay-off may be years – even decades – away?

By **Fiona Reynolds**, Managing Director, Principles for Responsible Investment (PRI)

According to the World Economic Forum *Global Risks Report 2017*, climate change is set to rank alongside income inequality and societal polarisation as a top trend for 2017. This year's report also noted that for the first time, all five environmental risks – which include extreme weather events, failure of climate change mitigation and adaptation, and water crises – feature among the most likely and most serious risks.

At the PRI, our signatories have indicated that climate is their most pressing concern in terms of posing material risks to their investment. Climate change is a cornerstone of our recently launched blueprint for responsible investment for the next 10 years. We plan to work with our investor base to ensure they keep engaging companies on this issue.

Climate change is just one of the many environmental, social and governance (ESG) issues that the PRI addresses. In just over the 10 years that the PRI has been in existence, we have seen consideration of ESG factors steadily move up the investor and corporate agenda as a way to realise better returns over the long term.

This mindset started to take shape post-financial crisis, when many investors began to question existing investment practices. The failure of traditional business

◀ **Statoil's gas processing and CO_2 removal platform, Sleipner T, near Stavanger, Norway. Norway's Oil Fund, the national pension fund financed from surplus petroleum income, is a strong proponent of divestment from fossil-fuel assets**

analysis to take into account a company's governance, compliance, basic corporate culture and leadership has produced a catalogue of poor business decisions. One has only to look at the recent example of Volkswagen to remind us that financial information in isolation might look appealing but it could be masking a host of unsavoury activities such as toxic waste dumping, use of child labour or overly aggressive tax practices.

We've also seen a confluence of factors, including high-profile policy-makers who are willing to publicly address the stark realities around issues such as climate change and the risks this presents for investors. For example, Mark Carney, Governor of the Bank of England, has referred to the "catastrophic risks" around climate change.

Research underway

Though data showing the correlation between ESG factors and returns has in the past been thin on the ground, research on this topic is finally catching up. Numerous studies from the University of Hamburg/Deutsche Asset Management, Oxford University/Arabesque Asset Management, Harvard, MSCI and others have highlighted how looking at ESG factors can improve returns over the long term.

According to research firm Cambridge Associates, over the past three years the MSCI Emerging Markets ESG Index has outperformed its parent index (the MSCI Emerging Markets Index) by 12 per cent on a total US dollar-based return. The company's analysts report that over half of this outperformance was based solely on ESG factors.

These factors comprise a wide variety of inputs, including carbon emissions, employee health and safety, and product sourcing.

Investors have a significant role when it comes to engaging with companies on ESG issues, particularly asset owners who are at the top of the investment chain. Many pension funds, for example, have for some time been looking at ESG across their own investments. As the Canadian Pension Plan stated in its 2014 annual report: "We consider responsible investing simply as intelligent long-term investing".

As the world moves inexorably towards a 2°C rise in global temperature, investors are understandably concerned about the risk of stranded assets at companies that derive the bulk of their income from energy production that utilises fossil fuels. Many companies faced with this risk are moving radically to alter their business models.

Perhaps one of the starkest indications of the growth of ESG thinking among the global investment community is the ongoing divestment from fossil-fuel assets. Major asset managers such as Norway's Oil Fund and France's AXA have engaged over the past few years in divestment from fossil-fuel assets.

Many other industry players are looking to follow suit. At the PRI, many of our signatories choose engagement over divestment because they feel that you can't influence behaviour unless you have a 'seat at the table'. However, for some, when engagement efforts fail, divestment may be the only option.

Governments and regulators are also taking heed of how ESG issues can build long-term value. Green finance initiatives – taking root from London to Beijing – are proving attractive as a way to take advantage of the falling costs of renewable energy and to reinvigorate economies through greater job creation.

With over 150 countries now committed to the Paris Agreement, and pledging to dramatically reduce their carbon footprint – mostly through the development of low-carbon energy and transportation infrastructure – it is vital that future infrastructure projects are both sustainable and climate resilient. Both the G20 and the Organisation for Economic Co-operation and Development are exploring how to direct more institutional investment into infrastructure, which can present an attractive opportunity for long-term capital.

Emerging markets in particular will require substantial investment in new green infrastructure to mitigate and adapt to climate change and support development objectives.

The new normal

The PRI recently developed a new infrastructure workstream, which will focus mainly on private debt and equity investments in infrastructure, both directly and via funds. It will also ensure consideration of material ESG factors in investment decision-making, and provide guidance on integrating responsible investment throughout the investment process, from origination to exit.

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The commercial reality is that investors adapting to the 'new normal' of a low/no return environment are seeking opportunities for higher yields. Long-term investors with lots of patient capital need a home for those funds – infrastructure and long-term sustainable investing are like a marriage made in heaven.

While the US's decision to pull out of the Paris Agreement was disappointing, activity around climate is unlikely to be derailed. If anything, we have found that the US decision has actually galvanised investors and other stakeholders to ramp up their climate policies. The slow but steady turning of the global capital markets towards ESG is proof of how the mindset of the financial community is turning away from the pure profit motive to a more holistic and nuanced investment model. ●