Sustainable investing: How effective is it really?

April 18 2022, by Renee Cho

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In October, a report released by the White House warned that "Climate change is an emerging threat to the financial stability of the United States."

The intensifying impacts of climate change can jeopardize businesses in numerous ways. Extreme weather events disrupt operations, make resources such as water or energy scarce or more expensive, and increase the cost of insurance, posing financial risks for those who invest in companies unprepared to deal with these impacts. Other attendant climate, environmental, and social impacts also have financial repercussions. The loss of biodiversity and ecosystem services could cost the global economy $2.7 trillion by 2030 according to the World Bank. Sea level rise threatens real estate and coastal infrastructure. Increasing water scarcity around the world—a McKinsey study estimated that global water demand will exceed the available supply by 40 percent by 2030—may disrupt supply chains and business operations. New regulations that drive a shift away from fossil fuels could introduce uncertainty into business decisions. And companies' reputations may suffer as investors increasingly favor more sustainable companies.

So is it less risky to invest with sustainability in mind? And does sustainable investing actually help the planet?

What is sustainable investing?

Security and Exchange Commission chairman Gary Gensler said that investors with over $130 trillion in assets under management have been asking for companies to reveal their climate risks. More and more investors, especially younger ones, want to invest in companies that take climate risks into consideration, and that are sustainable and socially responsible. They are demanding information about a company's relationships, how it conducts business, how it is governed, its supply chain practices, and its values. Sustainable investing is a strategy that seeks to ensure that companies produce positive social and environmental impacts as well as long-term financial gains. Such socially responsible investing is also called ESG investing because it considers the environmental, social, and corporate governance aspects of a business.

Companies are given ESG scores based on these factors:

Environmental: What impacts a company has on the environment—its carbon footprint, waste management, water use and conservation, and the clean energy and technology it uses.

Social: How a company deals with human rights, racial diversity in hiring, the health and safety of employees and board members, and community involvement.

Governance: How a company is governed or managed—the quality of management and the board, diversity, executive compensation, shareholder rights, transparency and disclosure, anti-corruption, and political contributions.

The growth of sustainable investing

In recent years, assets in sustainable mutual funds and exchange-traded funds (ETFs) have grown rapidly. From 2020 to the end of 2021, assets in these funds grew 52 percent to $362 billion. Broadridge Financial Solutions projects that ESG assets could reach $30 trillion by 2030. Despite this growth, however, sustainable investing does not necessarily yield greater returns. The authors of a new book on sustainable investing found no unambiguous evidence that sustainable investing out-performed traditional portfolios in the long run.

Meanwhile as money pours into ESG funds, the world's environmental and social crises continue to worsen. So is sustainable investing actually helping to combat climate change and advance a sustainable society? Lisa Sachs, director of the Columbia Center on Sustainable Investment, said, "What is being called sustainable finance, or what is expected of ESG investing is not what many of us would expect, which is an approach to investing that accounts for and minimizes negative impacts and brings positive impacts. There are a lot of different strategies, purposes, and approaches that are captured under the umbrella of sustainable investing or ESG investing. Those terms are often used interchangeably, but they don't all mean the same thing."

Three types of sustainable investing

For portfolio investors, there are three distinct approaches to sustainable investing, said Sachs. They are completely different in their goals, strategies, and effects on real-world outcomes.

1) Maximizing risk-adjusted returns

The idea here is that if you account for environmental, social and governance factors, particularly their risks and opportunities, you can make better investment decisions, maximize returns, and minimize risk.

For example, a major long-term threat to fossil fuel companies comes from increased social and political stigmatization of their activities. This stigmatization could lead to pressure on governments to levy a carbon tax or implement other regulations that would impact fossil fuel company finances and increase uncertainty about their profitability. But accounting for risks is no guarantee that there will be longer-term consequences such as stigmatization and government regulations that could influence company behavior. "Just accounting for those [ESG] risks in order to maximize returns is neither designed to, nor will it have an effect on real world outcomes," said Sachs.

2) Aligning portfolios with values

This entails excluding certain types of investments or specifically including certain types of investments in a portfolio in accordance with one's values. The growing divestment movement aims to avoid investing in fossil fuel intensive companies with the goal of forcing them to leave fossil fuels in the ground (stranded assets) or pressuring them to reduce their carbon emissions or move into alternative energy sources.

According to the Global Fossil Fuel Divestment Commitment Database, 1,508 institutions have committed to divestment. These include universities such as Harvard and Columbia, foundations such as the Ford Foundation, pension funds, faith-based organizations, and even governments. However, while these institutions are valued at over $40 trillion in total, this does not mean that they are divesting that amount of money.

And despite the important symbolism and growth of the divestment movement, Sachs said that research suggests that at its present scale, it doesn't actually affect the cost of capital or the behaviors of targeted companies. This is because divestment doesn't take any money from the coffers of fossil fuel companies since the shares have already been issued; when divested, they are simply being bought by someone else. Moreover, "Even if the maximum possible capital was divested from fossil fuel companies, their shares prices are unlikely to suffer precipitous declines," revealed an Oxford University report.

What could have an impact on company behavior, however, through adjusting the cost of capital, the availability of financing, and financing terms is if banks and private equity would divest. "Banks and private equity and those who are bringing new capital or underwriting capital, or determining the terms of capital, have more power to shift the cost of capital and the availability of capital, than do universities," said Sachs.

However, most are not using their power to advance sustainability. A new report revealed that the world's 60 largest banks have put $4.6 trillion into the fossil fuel industry since the Paris Agreement. U.S. banks JPMorgan Chase, Citi, Wells Fargo, and Bank of America are responsible for 25 percent of this funding despite being members of the international Net Zero Banking Alliance committed to reaching net zero by 2050.

3) Active stewardship

Shareholders of a company have power and influence over management and boards of directors and can take action. "Shareholders have the power to bring resolutions to ask management to take certain actions, and vote on others' resolutions. They do vote on directors, and that's one important way to hold directors accountable," said Sachs. "One could vote against any director that doesn't take sustainability concerns seriously."

As an example, Engine No. 1, an activist investment firm, was able to install three directors on Exxon Mobil's board in an effort to pressure the company into reducing its carbon footprint and consider the risk of climate impacts on long-term shareholder value. It achieved this by getting the support of Exxon's large institutional shareholders—BlackRock, State Street and Vanguard—asset managers who support the goal of net zero by 2050.

"This type of 'sustainable investing' is critical and valuable," said Sachs. "If all owners of capital were active stewards of that capital and were pushing management for more responsible practices and more responsible board management, I think that would be really great. But in the universe of 'sustainable investing practices,' or ESG practices, that is a very small sliver of what is normally included under that umbrella."

The challenges of sustainable investing

Because ESG strategies are designed to account for how real-world crises affect companies so they can reap better risk-adjusted returns, ESG ratings do not reflect a company's impacts on the real world—they rate how well a company is managing its risks.

Moreover, it is hard to know exactly what a company's ESG score means because rating companies do not reveal what risks they are assessing or their methods of rating. Companies are being rated on certain aspects, but not on others, and they are being rated from a risk perspective, not from an impact perspective. Sachs cited Coca Cola as an example. "They get a double A rating as a top ranked sustainability company. Probably because they are managing their water risks, and maybe looking at their climate policies, maybe looking at their labor policies. But that rating doesn't account for the fact that the core product—a sugar beverage—is leading to the largest public health crisis that we currently face." Nonetheless, Coca Cola is considered a best-in-class company for beverages. To create ESG funds, ESG portfolio companies bring together best-in-class businesses with high ESG ratings based on hidden factors that don't account for the overall impact of the company. "This makes it difficult for investors who want to understand which companies are 'sustainable' or are doing well," said Sachs. "That information cannot be gleaned by this [these scores]."

Some experts believe that sustainable investing actually inhibits climate action. Tariq Fancy, former sustainable investing chief at BlackRock, called sustainable investing a "dangerous placebo" because "it keeps government regulation to address the climate crisis at bay through feeding us yet another narrative in which our answers are solved by the 'free market' magically self-correcting." Sachs contends that the finance industry has helped delay government action to combat climate change because the private sector does not want regulations. Many businesses and financial sector entities are in fact lobbying heavily against the types of climate action sustainable investors want to see.

The diverse, unregulated, and inconsistent practices of sustainable investing are also a huge challenge to its efficacy. There are no accepted definitions of what constitutes a sustainable investment and so far, there have been no consistent regulations requiring disclosure of climate risks, or any consistent approach to accounting for emissions. Aside from sowing confusion, this lack of clarity has also allowed for "greenwashing," when companies claim to be more sustainable than they actually are, whether intentionally or not. Influence Map a U.K. think tank, studied 723 equity funds using ESG claims in their marketing; more than 70 percent of the funds with ESG goals were not aligned with the goal of the Paris Agreement—to keep global temperatures below 2°C above pre-industrial levels. More recently, Morningstar removed the ESG tags from 1,200 funds.

More effective sustainable investing

In March, the Securities and Exchange Commissions (SEC) proposed a new rule that would require all U.S. publicly traded companies to disclose to the government and to their shareholders how the risks from climate change could affect their business. It would establish a framework for companies to report the climate risks they face in annual reports and stock registration statements.

If the SEC rule is passed, its mandated disclosures about a company's governance, risk management, strategy with respect to climate-related risks, greenhouse gas emissions, climate goals, and transition plans, will force companies to back up any claims they make. SEC Chairman Gensler said, "…if adopted, it [the proposed rule] would provide investors with consistent, comparable, and decision-useful information for making their investment decisions and would provide consistent and clear reporting obligations for issuers." Disclosure of this information would also give investors more leverage to compel businesses to change practices that contribute to climate change and likely spur companies to be more sustainable.

Peter Drucker, an Austrian-American business leader, famously said,"You can't manage what you can't measure." As such, the SEC rule is an important step in the right direction, but it needs to be followed by action. Given the far-reaching implications of climate change, and the urgent need to curtail fossil fuel use and strengthen climate resilience, strong federal policies are essential to reduce greenhouse gas emissions. "Once we identify the problems, they need to be regulated, because we shouldn't be looking to the market to self-regulate based on these disclosures," said Sachs. "We need real regulations that address climate change. We should not look to our portfolios to effect the change that we want. We should look to our government officials, and we should not be disabused into thinking that the private sector or the financial sector are going to solve these problems."

If you are considering sustainable investing, understand the three strategies of investing and be realistic about the purposes, strategies, and outcomes of the ones you choose. Most importantly, be an educated and active investor. Do your homework in terms of how a company is managed, what its climate goals are, and what strategies it is using to achieve them, and actively engage its management. CERES, a nonprofit organization whose goal is changing corporate environmental practices, has developed tools investors can use to find out how companies are addressing climate change and water risks, how to assess company progress towards net zero goals, track shareholder proposals on ESG issues, engage with companies, and more; it also coordinates the Investor Network on Climate Risk to advance sustainable investment practices.

"We have the opportunity to align the capital that we have, and the capital that many in our generation want to be mobilized, for good," said Sachs. "To actually think about what it would look like to mobilize it for good and determine the proper investment opportunities, I think, are some of the most important questions of our generation."

More information: Report on Climate-Related Financial Risk

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Provided by Earth Institute at Columbia University

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