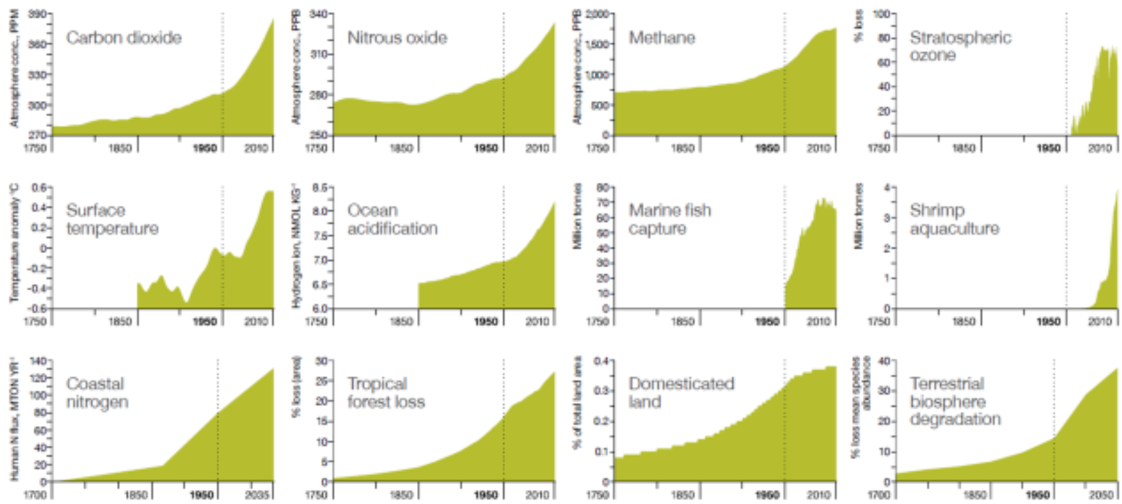
Sustainability trends: from economics to financial markets

By Maria Municchi

Crucial to successful asset allocation and delivery of investment returns is the understanding of the factors driving asset prices: economic, financial market and psychological. These are constantly evolving, although the pace and drivers of change can vary over time. Today, sustainability trends are having a significant influence over these areas. As sustainability issues are often interconnected, there are many reasons why and different ways in which sustainability factors might affect the way we invest.

This represents a significant shift in the mindset of economists. The extraordinary level of demographic and GDP growth since the 1950s, also known as the 'great acceleration', significantly affected natural ecosystems by increasing the level of carbon dioxide, methane and nitrous oxide in the atmosphere, as well as increasing ocean acidification and reducing tropical forests.



Ecosystem trends from 1750 to 2010

Steffen et al; *The Great Acceleration*

However, twentieth century economists failed to fully capture the importance of natural resources in the economic system, mainly considering the above trends as externalities (a cost caused to a third party by economic activity). But as the size and impact of those externalities and their interconnectedness becomes more evident, economists are starting to rethink the role of natural resources in economy and society.

A sustainable economy is one that works efficiently within natural as well as social boundaries (and one that, by definition, can sustain itself indefinitely). In order to achieve this, economic systems need to incorporate the cost of externalities by transitioning towards circular operating models designed to reduce waste, keep materials in use and regenerate resources. For this transformation to happen successfully, it would need to incorporate the concept of environmental justice – the fair treatment of all with respect to the development, implementation, and enforcement of environmental laws, regulations, and policies.

With the setting of the UN Sustainable Development Goals in 2015 (which include both social and environmental aims), governments, global initiatives and corporates have started to work towards the transition described above.

Economy

Governments all over the world have started to incorporate sustainability in their agendas and, more recently, into their fiscal policies. The US is one of the latest to do so, notably incorporating the concept of environmental justice. Certain Initiatives and increased data evidence are accelerating the way in which society, private entities in particular, are rethinking their operating models with the aim of transitioning towards lower carbon intensity.

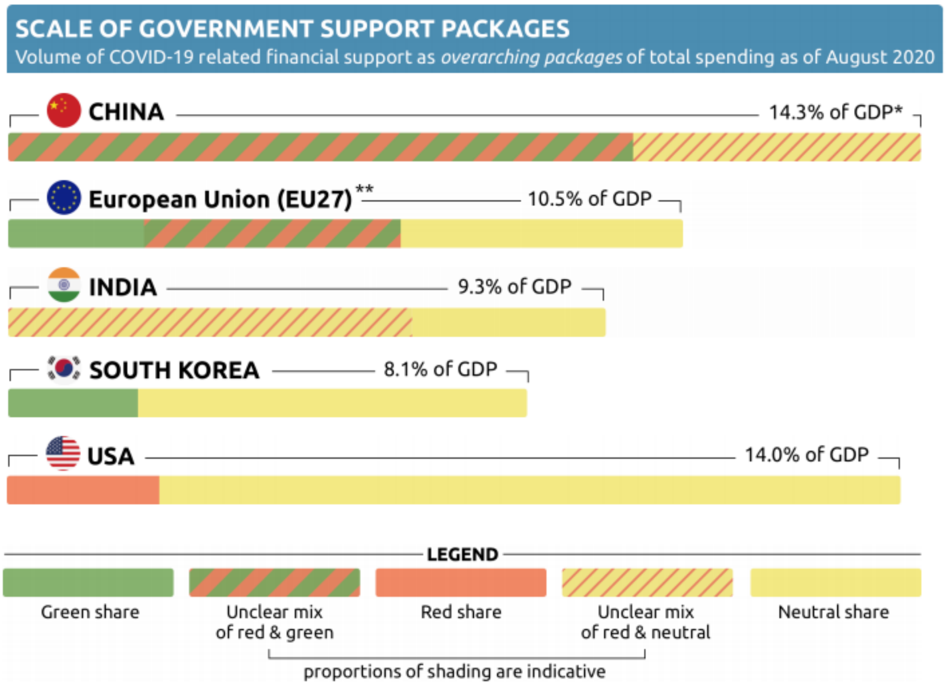
The initiatives include:

- The Task Force on Climate-Related Financial Disclosures (TCFD), created in 2015 by the international monitoring body the Financial Stability Board (FSB) to develop consistent climate-related financial risk disclosures for use by companies, banks, and investors in providing information to stakeholders. Increasing the amount of reliable information on financial institutions' exposure to climate-related risks and opportunities is intended to strengthen the stability of the financial system, contribute to greater understanding of climate risks and facilitate financing the transition to a more stable and sustainable economy.

- CDP, an international not-for-profit charity that runs the global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts.

- Science-based targets (SBT), which provide companies with a clearly-defined path to reduce emissions in line with the Paris Agreement goals. More than a thousand businesses around the world are already working with the Science Based Targets initiative (SBTi).

Targeted fiscal spending (see chart below) and businesses' transition plans towards lower carbon intensity are examples of how sustainability trends can affect the economy by altering the price structure and cost-benefit curve.



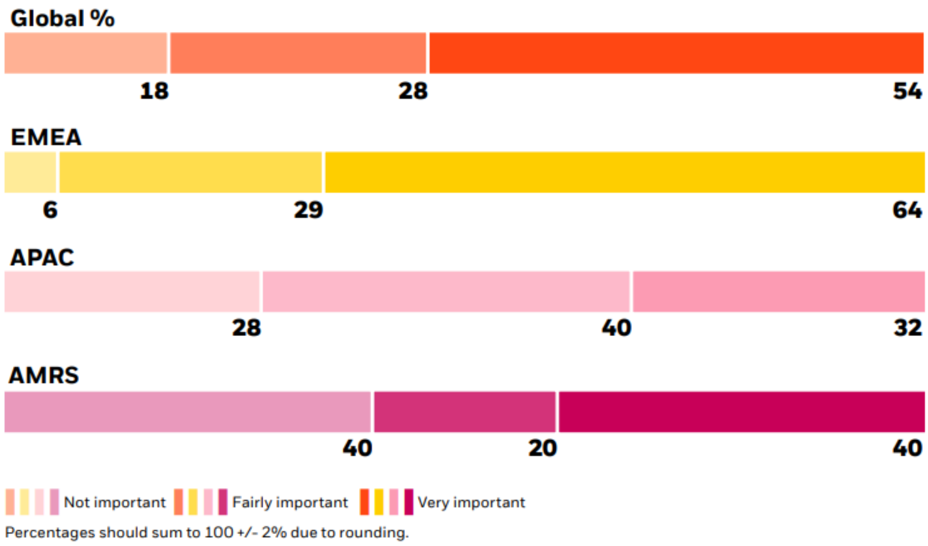
Climate Action Tracker

Markets

As significant progress is made in evidencing and assessing the ESG risks and opportunities of public and private investments, financial markets are starting to incorporate these factors in their pricing mechanisms. Although it is too early to ascertain if a company with a high ESG score is going to outperform (given the lack of back testing and variable nature of ESG risk), a company with good ESG credentials is often perceived to be better positioned and/or more advanced in navigating the transition towards a sustainable economy. For example, a company with good environmental characteristics might be less subject to physical and transition risk from climate change. Price response to change in financially-material ESG risks are one example of how sustainability trends can affect markets by effectively incorporating externalities.

Psychology

With regulations in many countries now requiring explicit confirmation of whether sustainability factors are included in the investment decision, investors' preferences relative to ESG and sustainability factors are shifting. Also, as the generational wealth transfer progresses, the demand for sustainability-aligned investing from younger generations is growing. Investor preferences for high ESG quality portfolios and a risk attitude towards non financially-material ESG risks are examples of how sustainability trends can affect market psychology.



Importance of sustainable investing, or sustainability, in investment processes and outcomes

BlackRock Global Client Sustainable Investing Survey, July-September 2020

In the context of the trends described above, it is crucial for the success of our investment strategies that sustainability and ESG factors are fully acknowledged and considered when making investment decisions and constructing portfolios.

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