Why sustainable investing is the future

Blog

We find life in virtually every pocket of the Earth. Even where there are extremes in temperature, acidity, pressure, salinity, or radiation, there are organisms that have adapted to these conditions in order to take advantage of otherwise-untapped resources. Life just...finds a way.

Financial markets are driven by a similar tendency: the guiding force of finding and exploiting inefficiencies. Investors have already tapped many of the most "nutrient-rich" inefficiencies (diversification, bond pricing, etc.). Many of those remaining offer only incremental value, while others (e.g. behavioral biases) can be harvested by hardy investors—"extremophiles"—who can stay the course through difficult markets and buy when others are fearful.

This brings us to the simple maxim underpinning sustainable investing (SI) as the future of investing: "Not everything that counts is being counted (yet)." It's true that SI is a social force, driven by investors working to change the world through voting with their dollars. But this isn't some passing craze, and it has clear financial return implications. In a world where investors are panning for any minor inefficiency they can find, SI represents a potential mother lode, because it stands at the locus of many of the most valuable inefficiencies remaining.

We've only glimpsed the full potential of pricing in environmental- and governance-related risks, and the value or risk of investing in global brands in an environment of rapidly shifting consumer sentiment, but there's little doubt that these factors have the potential to enhance investors' risk-adjusted returns. "Externalities" are a concept that helps to demonstrate the potential value of uncovering SI factors.

What are externalities?

In economics, an "externality" is a cost or benefit that isn't priced into a good or service. For example, consider the air pollution tied to the production of a stroller. Externalities can also be social; for example, individual vaccinations help create a "herd immunity" for the population.

Governments usually address externalities using something that economists call a "Pigovian tax": a tax or subsidy to "internalize" the social impact, aligning the costs and benefits of consumers and producers with those of society. For example, the government can apply a "carbon tax" to pass emissions costs onto stroller producers and consumers; by doing so, these pollution considerations become a natural part of deciding which stroller to produce or purchase. In the case of vaccinations, they can be encouraged by legal requirements or subsidies.

One of the key drawbacks to Pigovian approaches is that they can create unintended consequences, some of which can be contrary to the aim of the tax or subsidy. For example, if the US taxes carbon emissions, corporations can shift production overseas, *adding* to global emissions by requiring those products to be shipped great distances. In a globalized economy, where countries compete for business through subsidies and looser regulations, loopholes are largely inevitable.

Today, the ozone layer has finally begun to heal from the damage caused by chlorofluorocarbons. Even though the global response to this crisis is one of our best examples of international cooperation, it still took decades to implement a global solution. To paraphrase John Hammond, our lives are in governments' hands, but they've got butterfingers.

That's not great news for society, because it means that it will take a long time to address social, environmental, and governance problems. But these Pigovian loopholes offer a distinct opportunity, and investors who are ahead of the curve in pursuing sustainable investing stand to benefit from identifying and addressing these inefficiencies.

How does SI bridge the divide?

There are several ways through which SI addresses externalities: formalizing and quantifying previously hidden data, rewarding firms who are leading the way, engaging to help firms address shortfalls, and creating investments to reward solutions that directly impact on society.

Consider investing before the advent of credit ratings; in this environment, investors could benefit significantly by doing their own credit analysis. Similarly, SI investors are poised to unlock a myriad of opportunities by quantifying variables, and incorporating them in the investment process.

As markets incorporate each new SI factor brought to light, SI is quickly becoming mainstream. Soon, SI won't even be seen as separate from core investment analysis, but it will continue to generate societal benefits and improved returns for years to come. In theory, many of the best returns will accrue to SI pioneers, and it's better to be ahead of the evolutionary curve, in our view. After all, the traditional investment approaches—which ignore these risk and return factors—will eventually go extinct.

To understand more about SI, and how to take advantage of these trends, please visit our SI website.

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Appendix

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