Tackling the sustainability conundrum

BY JOSEPH MARIATHASAN | MAY 2023 (MAGAZINE)

With climate change and the loss of biodiversity seen as potential existential risks for humanity, it has become imperative to create and implement a sustainable form of capitalism. Creating private profits for shareholders at the expense of unaccounted losses for the public at large is no longer acceptable. Investors have a crucial role in this transformation by creating portfolios of assets that are sustainable over the long term.

The concept of sustainability may be difficult to argue against in theory. In practice, the fundamental challenge is that the time horizons over which CIOs and asset managers are assessed usually do not extend beyond three to five years, while the impacts of investments on the environment may not be evident for decades. Environmental, social and governance (ESG) ratings have added more confusion than clarity with hundreds of different methodologies based on subjective qualitative analyses giving rise to results that show little correlation with each other.

For Fiona Frick, who recently stepped down as CEO of Unigestion after 12 years at the helm and over 30 in the company, implementing a sustainable approach to investment for asset owners has become her life's goal. Earlier this year she founded consulting firm Circe Invest to help asset owners and managers integrate sustainability into asset allocation and balance performance with social and environmental responsibilities.

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Fiona Frick

Integrating sustainability risk into a portfolio framework is not a new concept for Frick. As an equity manager more than 20 years ago, she was asked by Scandinavian clients why the firm was not integrating sustainability risk into its portfolios.

The solution was to exclude stocks in sectors that were seen as unacceptable. It produced portfolios that appeared to show no decline in returns, with less volatility. Frick says: "Those stocks had a risk which had no premium, so we started implementing exclusions across the board in equity."

But reducing the universe of opportunities through excluding large numbers of stocks also reduces the potential for generating outperformance. One solution was to move from exclusion to integration through engagement with management on issues relating to sustainability.

Sustainability across assets

When Frick became Unigestion's CEO in 2011, her objective was to integrate sustainability not just in equity, but across all other investment lines while developing a corporate social responsibility framework for the firm itself. The firm also launched two impact products focused on addressing climate change – one for listed equities and one for private equity.

Frick's passion for impact assessment as a key pillar of investment alongside the traditional framework of risk and return has spilled over into her new initiative. Her new firm aims to act as a bridge between investment and impact for asset owners. As well as generating returns commensurate with risks, she says that "the role of finance is to allocate more funds to those companies that have a positive purpose in society and to allocate less to those which do not".

She says that finance has an image problem, and has teamed up with her sister, who has a background in marketing in the luxury goods sector. Frick will also partner with technical experts to provide analysis.

Lack of good data

Clearly, there is much to be done in a marketplace that has become overwhelmed with data of the wrong type, amid widespread evidence of 'greenwashing' and a rapidly changing regulatory framework. The reporting of sustainability data by corporations leaves a lot to be desired. The creation of the International Sustainability Standards Board (ISSB) should add some impetus to improving disclosures, but even the ISSB with its focus on the reporting only of factors that impact corporate valuations (single materiality) has come under criticism for not stipulating reporting of data that impacts all stakeholders (double materiality).

However, as Frick says, "you have to start somewhere". Impact reporting on the environment, human capital and social capital can relate both to the operational impacts of corporations' activities and also to the impacts of their products and services. But there is clearly a difference between, say, the positive impacts of insulin produced by Novo Nordisk and the negative impacts of BAT's tobacco products. Giving a monetary value for each may produce too large a margin of error to be useful, but Frick argues that investors can start by giving qualitative scores until the data improves.

Perhaps more surprising is that companies' operational impacts are not better measured. The data on greenhouse gas emissions, waste production, water usage and the like is progressing slowly and lacks common standards. Better data would help put monetary valuations on operational impacts.

New portfolio theory

Frick says investors could create a "sustainable portfolio theory" to replace the two-dimensional risk/return "efficient frontier" of modern portfolio theory with a three-dimensional surface.

Frick believes that all asset classes should be looked at through a sustainability lens, and should incorporate assessments of impact. Real estate investments, for example, should be valued at a premium if expenditures were devoted toward better energy efficiency, since the value of the properties would be positively impacted in the case of a sale. Bonds should have higher credit spreads if they are issued by entities with higher negative impacts due to higher reputational and regulatory risk.

Frick expects the risks and returns of conventional sustainable strategies over the next decade to gradually match those seen in non-sustainable strategies due to market efficiency but says "investors need to have a long-term view".

She points out that some countries have a framework that incorporate impact more easily in asset allocation. Several Scandinavian pension funds have an impact bucket, for example, but funds in other countries do not. "[As a result,] the asset owner struggles because integrating impact strategies in an asset class creates an active risk budget which needs to be measured and the premium for that risk could take time to materialise," she says.

Reconciling the worlds of impact and investment in asset allocation is a challenge that is likely to keep Frick busy for many years to come.

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