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WEALTH MANAGEMENT

HOW TO PLAN, INVEST AND PROTECT YOUR FINANCIAL ASSETS

SECOND EDITION

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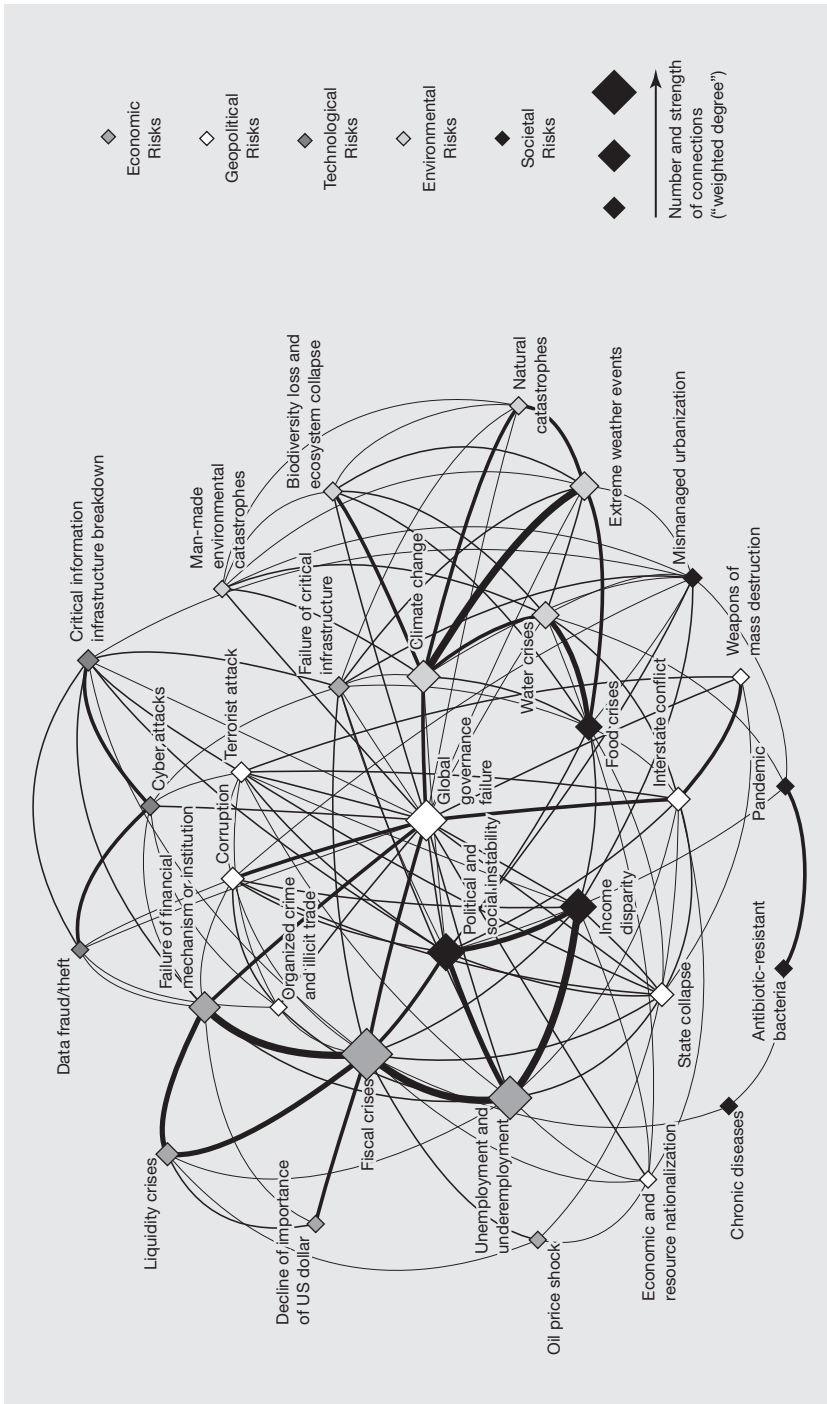

Figure 7.5 Global risks to human prosperity

Source: World Economic Forum.

2°C. This increase is equal to burning about 565 gigatons of carbon until 2050.[2] However, the amount of carbon already contained in the proven coal and oil and gas reserves of the fossil-fuel companies and countries is actually almost five times as much – 2,795.[3]

> **'Yes, this coal and gas and oil is still technically in the soil. But it's already economically above ground – it's figured into share prices, companies are borrowing money against it, nations are basing their budgets on the presumed returns from their patrimony. It explains why the big fossil-fuel companies have fought so hard to prevent the regulation of carbon dioxide – those reserves are their primary asset, the holding that gives their companies their value. It's why they've worked so hard these past years to figure out how to unlock the oil in Canada's tar sands, or how to drill miles beneath the sea, or how to frack the Appalachians.'**[4]

Another recent research paper suggested that 'a precautionary approach means only 20% of total fossil fuel reserves can be burnt to 2050'.[5] This concept is shown visually in Figure 7.6, based on 50% and 80% probability of reaching various levels of warming for given levels of carbon. The researcher had this to say about the impact of carbon on the UK stock market:

> **'The CO2 potential of the reserves listed in London alone account for 18.7% of the remaining global carbon budget. The financial carbon footprint of the UK is therefore 100 times its own reserves. London currently has 105.5 GtCO2 of fossil fuel reserves listed on its exchange which is ten times the UK's carbon budget for 2011 to 2050, of around 10 GtCO2. Just one of the largest companies listed in London, such as Shell, BP or Xstrata, has enough reserves to use up the UK's carbon budget to 2050. With approximately one third of the total value of the FTSE 100 being represented by resource and mining companies, London's role as a global financial centre is at stake if these assets become unburnable en route to a low carbon economy.'**

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2 Meinshausen, M., Meinshausen, N., Hare, W., Raper, S. C. B., Frieler, K., Knutti, R., Frame, D. J. & Allen, M. Greenhouse gas emission targets for limiting global warming to2°C. Nature, doi: 10.1038/nature08017 (2009).

3 Leaton, J, 'Unburnable Carbon 2013: Wasted capital and stranded assets' – Carbon Tracker (2013).

4 *Rolling Stone* – 'Global Warming's Terrifying New Math' Bill McKibben 12.08.12.

5 Ibid footnote 3.

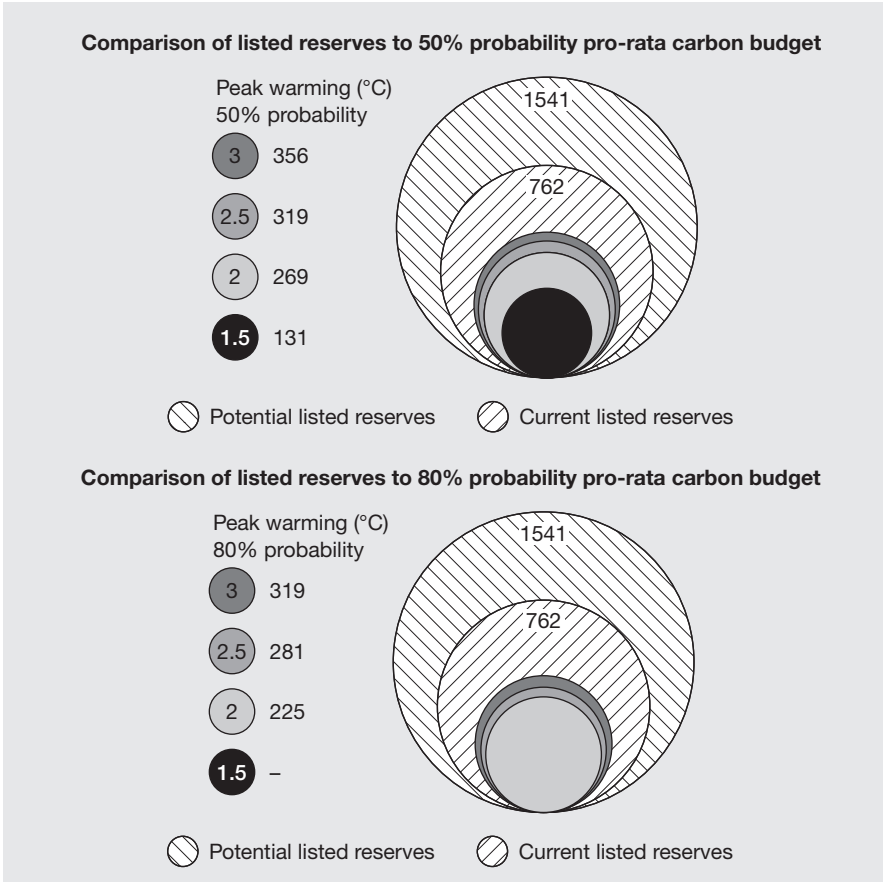

Figure 7.6 Unburnable carbon – listed carbon reserved compared with climate change maximum useable

Source: Carbon Tracker.

The majority of institutional investors and a minority (but growing) proportion of individual investors invest significant amounts in passive funds that track the UK and international stock markets. An even larger proportion invests in actively managed investment funds that are benchmarked against market indices. So, one way or another, most investors have significant exposure to companies that are valued on the basis of huge fossil fuel reserves, which may never be possible to use.

As we explored in Chapters 5 and 6, finance theory suggests that capital markets do a good enough (although not perfect) job of pricing risk and as such current prices should reflect all known information. If this is the case, how can it be that the world's brightest and cleverest people working in investment banks and fund

management companies are not pricing the externalities associated with energy companies' assets which, based on the science, they can never use? Experts in this field have suggested various theories, but perhaps the main one, which intuitively might make sense, is the fact that the investment world is using flawed valuation metrics based on outdated business and economic models, and that have not been adapted to the new environmental reality.

Implications for investors

In my view there seem to be five possible approaches you could adopt to deal with the various externalities that investment markets don't or can't factor into current securities prices:

1. Maintain a traditional unfettered passive investment strategy and allocation, rebalancing as necessary in the light of market movements, on the basis that any repricing of risk will happen gradually over time and eventually be reflected in world stock market values.
2. Overweight the portfolio to thematic and multi-thematic funds that focus on alternative energy, forestry, clean water and other trends connected with the environment.
3. Allocate capital to private equity that invests in renewable energy and other innovations such as carbon capture and storage.
4. Invest in a passive portfolio that applies a sustainable investment screen.
5. Do a mixture of 1–4.

Before you decide on your approach we need to consider the potential role of a more recent innovation in the world of investing, that of sustainable investing.

Sustainability

While 'sustainability' may have different meanings to different people, the term is often associated with general concern for the environment. The United Nations describes sustainable development as 'development that meets the needs of the present without compromising the ability of future generations to meet their own needs'.[6] With this framework in mind, business practices that exhaust resources or cause irreversible changes to the earth's climate are considered unsustainable.

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[6] United Nations (1987) 'Report of the World Commission on Environment and Development', General Assembly Resolution 42/187, 11 December.

Sustainable investing is different from other types of SRI because it uses much more objective screening criteria, based on measuring, rating and ranking the things that scientific consensus identifies as being important to sustainability. Examples[7] of business practices that relate to sustainability include the following:

- Reducing resource consumption: sustainable companies are efficient in their use of natural resources – particularly non-renewable resources and energy that contribute to global climate change.
- Reducing emissions of toxics and pollutants: companies that emit harmful chemicals, break environmental laws or show wanton disregard for local environments are not performing sustainably.
- Implementing proactive environmental management systems and initiatives: embedding environmental thinking into the business structure maximises sustainability thinking at every point, rather than only after the fact.
- Helping customers achieve sustainability: thinking beyond the walls of the company to design products that reduce the environmental impacts during product use is key to sustainability.

With these business practices in mind, it is then possible to develop a screening process and apply this to the universe of equities and/or bonds to determine which holdings are sustainable. There are various ways that the sustainability screening can be done but the approach of one leading investment manager is shown in the box.

Rank companies within industries on these factors:

- Climate change variables – 30% weighting
  - Sector-normalised CO_2 emissions intensity
  - Climate change solutions users
  - Climate change reporting
- Environmental vulnerability variables – 35% weighting
  - Hazardous waste
  - Environmental regulatory problems
  - Toxic emissions
  - Environmental controversy
  - Environmental negative economic impact

[7] Sustainable Holdings & Esty Environmental Partners, Environmental Sustainability Ratings.

- Environmental strength variables – 35% weighting
  - Environmental management systems
  - Pollution prevention
  - Recycling
  - Environmental initiatives
  - Beneficial products and services
- Overweights: those that score above average
- Underweights: those that score below average
- Excludes the worst 10% in each industry

Source: Dimensional Fund Advisors Inc.

Expected returns – market versus sustainable portfolio

Having applied a sophisticated sustainability filter to the universe of securities, we then need to ask ourselves what impact, if any, this will have on expected returns compared with investing without the filter. Factors that suggest higher expected returns from a sustainable portfolio include the fact that such firms are better prepared for the future, will profit as more consumers make green choices, and have lower risk exposures to disaster, regulations and negative PR. Factors that suggest lower expected returns from a sustainable portfolio include the fact that this type of investing is more costly to research and implement, many companies might package themselves as green but are far from being truly sustainable in reality, and, if sustainable firms are lower risk, they must by definition deliver lower returns.

On balance it would seem that the return enhancing and reducing factors balance themselves out and the expected returns from a traditional and a sustainable portfolio should be broadly similar. However, there are explicit and implicit costs involved in SRI in general, not just sustainable investing. Explicit costs relate to the research and screen process so the total ongoing cost of SRI funds might be higher than that of non-SRI funds. Implicit costs relate to the opportunity costs arising from the screening process excluding companies that might have higher realised returns. In addition, because the universe of companies that the fund holds is smaller, there is some reduction in diversification, leading to a slight elevation of