“Doing Well by Doing Good”
Environmentalism and the Role of Responsible Investing

July 2020
Marcus Arcanjo
Introduction

Financial markets make the world go around, whether we like it or not. The most ambitious goals of the Paris Agreement cannot be achieved without the successful integration of environmental considerations in investment decisions. From large green bonds to smaller investments by individuals, ensuring funds are invested responsibly provides both opportunities and challenges for the future.

This paper explores the rapidly growing role of responsible investing in combatting environmental, social, and governance (ESG) issues, focusing specifically on the environmental aspect. It supports the view that investors play an essential role and have influence through their financial capital to change the status quo. Moreover, there are significant opportunities for strong returns for investors in a low-carbon economy, especially as these new industries are in relative infancy and have large growth potential.

Equally important is for investors to realize that responsible investing is not simply about making the “correct” decision morally or ethically but also about limiting climate risk across many industries represented within their portfolios. Lastly, the challenges that come with investment changes are discussed, including getting buy-in and promoting companies and investors to have greater transparency.

The Need for ESG Investing and Opportunities, and Progress So Far

The UN Principles for Responsible Investment (PRI) defines responsible investing as “an approach to investing that aims to incorporate ESG factors into investment decisions, to better manage risk and generate sustainable, long-term returns.” While they include governance of businesses and impact on social issues (such as human rights), environmental challenges have taken the spotlight. Nonetheless, for investors that have been successful in their current approach, one obvious question remains: Why should I adjust my portfolio to integrate ESG considerations?

Recently, climate change has ranked as the highest priority ESG issue faced by investors. This is unsurprising as we continue to see climate risks undervalued, leading to billions of dollars in damages annually. A key consideration lies in the interconnected nature of climate risks, which means there are knock-on effects that threaten to seep into many sectors as extreme weather events are not confined to a single industry. Losses are also difficult to compare because they can be measured in terms of economic performance or physical loss of assets.

For example, Frame et al studied the economic impacts of Hurricane Harvey, finding an average estimate of damages of around US $90bn. Using an event attribution framework to determine the “fraction of attributable risk,” they concluded that at least US $30bn (and possibly up to US $72bn) in damage was due to human-induced climate change. Perhaps most significant of all is the fact that these enormous estimates only include direct damages and do not account for associated issues such as mortality and displacement that are extremely challenging to accurately quantify in monetary terms. This damage affected real estate and the insurance industry, led to the loss of income for thousands of businesses, and impacted many other areas.

In New Zealand, researchers calculated the loss caused by two droughts in 2007 and 2013 and found that they jointly reduced GDP by US$3.4bn, of which around US $568m can be attributed to climate change. Extreme weather events wreak havoc throughout supply chains and across industry boundaries, creating the potential for enormous financial losses. While encouraging
investors to make the morally and ethically correct decisions may be preferable, getting them to adjust their portfolios according to potential financial risk is far more realistic. Therefore, educating investors on how climate risks manifest and how they can be financially detrimental may be more likely to facilitate real change in investor behaviour.

It is also imperative for investors (and businesses) to realize the potential positives of integrating climate-conscious decisions into portfolio allocation decisions. Kim and Lyon (2011) studied how companies’ share prices were affected by participation in the Carbon Disclosure Project (CDP)—an organisation that supports businesses and governments measuring and managing their climate risks through engagement, reporting, and disclosure. They found that participation alone was not enough to raise share prices, but CDP participants increased shareholder value when the probability of greater climate change regulation increased, to the tune of US $8.6 billion.¹ In other words, investing in climate-conscious companies can increase shareholder value.

ESG sceptics often argue that responsible investing cannot withstand turbulent economic conditions. However, the performance of ESG funds has outshone their non-ESG competitors during the coronavirus pandemic, largely because of risk management forming a key part of ESG practices.² Traditionally, “safer and reliable” investments in areas such as travel and energy have suffered greatly, with multiple airlines and oil companies filing for bankruptcy and tens of thousands of workers losing their jobs. That said, many would argue that investing specifically with ESG aims in mind carries additional, unnecessary costs, such as opportunity costs. Yet, Fu et al (2020) argue against this idea, saying that ethical investing, such as in a carbon-free portfolio, has no performance cost, despite having a significantly smaller pool of shares to select from.³

Returns, risks, and costs have shown ESG investments to be solid choices. Therefore, it is of little surprise to see that industry giants have begun to shift their portfolios. Earlier this year, Vanguard, responsible for over US $6 trillion in assets, called on companies to limit their environmentally destructive practices. Having such a significant stake in many large companies comes with influence in boardroom voting decisions, a position they can use to leverage climate decisions. They have pushed oil giant Exxon to do far more and were instrumental in passing a resolution that increased Chevron’ transparency, arguing that transparency “will help articulate consistency between private and public messaging in the context of managing climate risk and the transition to a lower-carbon economy.”⁴ This is an encouraging step given the notable lack of transparency and often conflicting public statements and private actions of oil companies. Elsewhere, Vanguard’s competitor BlackRock announced earlier this year that they will no longer be investing in companies that do not work towards significantly reducing their emissions. With US $7.3 trillion of assets under management, BlackRock could set the example for other asset management companies to follow.

Well-known asset managers changing their behaviors is not the only area where progress can be made. Sovereign wealth funds (SWF) provide opportunities to invest vast sums responsibly. By definition, an SWF is a state-owned investment fund comprised of pooled money from a country’s reserves. These funds are used for investment to benefit the country’s economy and citizens.⁵ The largest SWF is Norway’s Government Pension Fund Global (GPFG), set up in 1990 to ensure wealth gained from oil and gas could be used to benefit the country in the future. The fund controls over US $1 trillion, growing by 19.9 percent in 2019—an equivalent of approximately US $180,000 per person. They state that sustainable development is a precondition for return on financial investments in the long term.⁶
This year, the fund announced a plan to sell their stake in oil and gas exploration firms and shift towards climate-conscious alternatives. Indeed, the fund has divested from many companies since its inception in response to issues such as environmental damage, production of harmful substances (e.g., tobacco), and human rights abuses. Managing such a fund comes with power and influence that sends two signals to the market and companies: money will not be invested if they behave detrimentally and existing investments will be pulled should they fail to meet targets. A survey of sovereign investors found that 60 percent now incorporate a top-down ESG policy.

Lastly, there is a need for ESG investing because the relative infancy of low-carbon businesses and technologies provides ample opportunities for growth. Although renewable energy has gained traction in recent years, the industry as a whole is small compared to traditional fossil fuel companies. With many companies competing to solve challenges such as energy efficiency and large-scale renewable access at a reasonable price, investors have the chance to profit from technological innovation in these areas. As more governments commit to pursuing a clean recovery in response to coronavirus, investing in low-carbon companies will likely yield better results, both in terms of financial gain and reputation.

**Stranded Assets, COVID-19, and Challenges Ahead for ESG Funds**

Responsible investing is a hotly debated approach that comes with multiple challenges. For example, divestment strategies currently used may be unsustainable in the long-term and the few funds that are ESG-specific lack the necessary liquidity to make them attractive opportunities. Moreover, simply getting investors on board with caring about ESG approaches creates difficulties; most investors care about their returns far more than how those returns are achieved.

To facilitate meaningful action in this area, it is vital to change the narrative to inform investors that environmental disasters and climate change create enormous risks. Shifting such perceptions requires better education of and better engagement with both institutional investors and individuals.

One way to create change is through pension contributions; pension funds around the world account for tens of trillions of dollars. But this approach is not without its problems. Most contributors have limited choice, and little interest, in how their money is used. In recent years, the number of ethical pension funds has increased significantly but, on the whole, people do not usually change from the default contribution. It would be beneficial for employers to encourage people to explore the option of responsible investing as it could have a significant impact on the investment decisions of the pension fund management company.

Unfortunately, limited ESG investing choices are not confined to pensions. Individuals wishing to invest separately in pensions do not, for the most part, look specifically at ESG factors. Moss, Naughton, and Wang (2020) studied the investing habits of retail (nonprofessional) investors by observing their behavior in response to disclosures or press releases involving ESG measures. They found no routine difference in standard portfolio adjustments. Retail investors are more likely to change their portfolios in response to earnings reports. Again, highlighting that income and profitability trump ESG considerations for most investors.

For big investors and companies alike, a major area of concern is stranded assets. The University of Oxford defines stranded assets as those “that have suffered from unanticipated or premature write-downs, devaluations or conversion to liabilities. They can be caused by a range of environment-related risks and these risks are poorly understood and regularly mispriced.” To
achieve the goals of the Paris Agreement and limit warming to 2°C (preferably 1.5°C), research by McGlade and Ekins (2015) suggests that a third of oil reserves, half of gas reserves, and over 80 percent of coal reserves must remain unused. Therefore, continued investments into fossil fuels and policymakers’ instincts to rapidly exploit their territorial fossil fuels are, in aggregate, inconsistent with their commitments to this temperature limit.”

Naturally, the thought of leaving such a vast amount of resources untouched and unused will be seen as a lost opportunity for companies in those industries and the investors that support them, especially with the high sunk costs spent on such infrastructure. Some estimate stranded assets in energy alone costs around US $900 billion. However, a 2020 study by Sen and von Schickfus analyzed a German climate policy proposal aimed at stranding fossil assets. They found that investors are concerned with the risk of stranded assets but believe they will be compensated for them, therefore “they do not believe that they will be financially affected – neither by general unburnable carbon risk nor due to specific policy proposals implying the stranding of assets.”

Furthermore, although the risks of stranded assets are now reasonably understood and acknowledged, the potential losses are not priced into company valuations. Such financial risks are compounded as costs of capital for energy companies are already rising significantly and with continued stagnation in the price of their shares, the threat of hundreds of billions in lost value is growing. In June, as a result of the waning demand caused by the COVID-19 pandemic, Shell announced that the value of their assets may fall by US $22 billion. Likewise, BP told investors that they may lose US $17.5 billion in assets.

As economic and travel activity begins to pick back up, so too will oil demand. However, times are changing. With many governments committing to using this time as an opportunity to rebuild better, the landscape of the oil industry may have permanently changed. The shift to a low carbon future was highlighted recently when BP sold its petrochemicals business in a move that would cut CO2 emissions. Groups have called on the oil giant to invest the money from the sale in renewable energy.

Whether investors wish to take a chance on continued support for big players in the energy business is yet to be seen. The reputational risk may outweigh potential financial benefits. At a time where information is so freely available and news travels fast, those actively involved in reckless actions or the investors supporting them will likely face the wrath of the public. For example, the Deepwater Horizon oil spill by BP in 2010 in the Gulf of Mexico led to an outpouring of public criticism. This catastrophe led to an enormous sell-off that even now, a decade later, the share price trades at around half of the pre-spill level.

Lastly, as mentioned previously, an enormous challenge that befalls investors is a lack of transparency, both in companies’ ESG disclosures and announcements and in decisions of asset managers. Getting reliable and trustworthy information to use as a basis for making responsible investment decisions is difficult. Public commitments do not necessarily equate to real change. Investors may fall victim to greenwashing—a process whereby companies publicly announce climate measures to seem more environmentally friendly than they are—making highly polluting companies seem far more attractive as an investment. For example, Shell announced US $300 million in investing in natural ecosystems over three years. On the surface, this is an enormous figure. However, when you consider they spent US $25 billion on oil and gas in 2018, it makes it considerably less impressive. Digging around into annual statements, you will find that the little reference to environmentally-friendly practices is placed alongside fracking and LNG extraction, two processes that carry their own environmental burdens. It is a fact that the cash titans for energy companies are oil and gas, both of which are key components of plans for future growth.
Concerningly, Shell’s actions are not especially egregious in the context of the wider industry. The International Energy Agency (IEA) published a report on energy generation in 2019 and found that capital expenditure for oil and gas companies was comprised of 99.2 percent fossil fuels and 0.8 percent renewables. Therefore, it is hard for investors to differentiate between high-carbon companies making a genuine attempt to change course and those doing the bare minimum to save reputation while continuing harmful practices behind the scenes. This is not to say that companies are incapable of change nor is it meant to criticize those attempting to do better.

Transparency within climate and environmental decisions and disclosures remain an issue. While PRI found that 591 investors signatories totalling US $49 trillion in assets voluntarily reported on climate risk indicators in 2019, an increase of 111 investors from the year before, a survey by ShareAction found that 39 percent of asset managers make no mention of climate change in public policies and only 21 percent have a dedicated policy. The same organisation asked asset managers about their approach to biodiversity within investment decisions and they found that 0 percent integrate such concerns.

Equally, information on voting on climate change and environmental decisions is limited. 45 percent of asset managers do not publicly disclose their votes and only 17 percent explain their choice. Naturally, this makes it very difficult for investors to understand the stance that asset managers take. As mentioned previously, Vanguard has taken steps recently to prioritize climate action but historically they supported climate resolutions only around 10 percent of the time.

To ensure investors have access to good information to make their decisions, greater transparency and reporting is essential. Luckily, several tools and frameworks are in place. For example, the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD) has created a voluntary reporting framework and the Transition Pathway Initiative (TPI) tool created by the Grantham Research Institute on Climate Change and LSE is aimed specifically at investors so that they can assess companies on their climate impacts.

Conclusion

Evidence points to the fact that “doing well by doing good” is more than just a cliché slogan that acts as the posterchild for ESG investing. There are real opportunities for investors to gain through exercising social and financial responsibility. This can be done in many ways, from individuals learning about their pensions to voting for resolutions at annual general meetings to not falling for empty promises from environmentally destructive companies. Real responsibility does not lie solely in financial benefits for clients but rather the impacts and outcomes of investments on the public as a whole.

Nonetheless, challenges lie ahead. Many investors care about their bottom line and high returns more than behaving responsibly. Gaining buy-in from institutional investors and managers responsible for large portfolios will be difficult. They must navigate the minefield of conflicting interests and potential smokescreens of information. High-carbon companies must not cover their detrimental actions with much smaller positive actions towards environmentalism. It is just as important for investors not to fall for it.

Marcus Arcano is a Research Fellow at the Climate Institute. He holds an MSc in Development and Security from the University of Bristol and a BSc in Business Economics.
Notes

1 Schroders. 2019. ESG considerations for official institutions. Available at: https://www.schroders.com/de/sysglobalassets/digital/events/pdfs/oi-and-esg-thought_leadership_brochure.pdf


7 German, B. 2020. BlackRock pushes U.S. oil majors harder on climate efforts. Available at: https://www.axios.com/blackrock-us-oil-companies-climate-change-82bc14a0-146d-44bd-9efc-871e2de00295.html

8 Sovereign Wealth Fund Institute. 2019. Available at: https://www.swfinstitute.org/research/sovereign-wealth-fund


11 Institutional Asset Manager. 2019. Over half of sovereign wealth funds now have a top down policy as ESG spreads to fixed income. Available at: https://wwwinstitutionalassetmanager.co.uk/2019/09/30/279078/over-half-sovereign-wealth-funds-now-have-top-down-policy-ESG-spreads-fixed


14 Caldecott, Ben; Tilbury, James and Carey, Christian. 2014. Stranded Assets and Scenarios: Discussion Paper. Smith School of Enterprise and the Environment, Oxford University. Available at:

16 Livsey, A. 2020. The $900bn cost of stranded energy assets. Financial Times. Available at: https://www.ft.com/content/95efca74-4299-11ea-a43a-c4b328d9061c


18 BBC. 2020. Shell takes $22bn hit over low oil prices. Available at: https://www.bbc.co.uk/news/business-53233702

19 BBC. 2020. BP sells petrochemicals business to Ineos in $5bn deal. Available at: https://www.bbc.co.uk/news/business-53222946


25 ShareAction. 2020. A ranking of 75 of the world’s asset managers approaches to responsible investment. Available at: https://shareaction.org/research-resources/point-of-no-returns/#ranking-heatmap


27 Transition Pathway Initiative. 2019. How Investors can use TPI. Available at: https://www.transitionpathwayinitiative.org/tpi/investors