INVESTMENT WEEK

ESG hub

Fiona Frick: Applying Tolkien philosophy to sustainability

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Image: Fiona Frick (pictured), is managing partner of Circe Invest

How does Gandalf's famous quote, "All we have to decide is what to do with the time that is given us," in J.R.R. Tolkien's book, 'The Fellowship of the Ring' relates to investment and sustainability considerations?

Integrating sustainability considerations into an asset allocation framework is a crucial element in achieving long-term investment return targets.

However, accurately predicting when these considerations will be fully reflected in market pricing poses challenges.

Barbie film is a win for sustainable voices among ESG economy debate

Investors face a dichotomy in objectives, balancing the pursuit of long-term returns while minimizing short-term active risk.

In essence, Gandalf's quote highlights the need for investors to make thoughtful choices when considering different time frames.

Incorporating sustainability in the strategic asset allocation

Asset allocators should not overlook the need to prepare for an impending shift.

Environmental and societal factors, such as climate risk, biodiversity loss, and social inequalities, will increasingly impact the long-term risk and return profiles of countries, sectors, and companies.

By incorporating sustainability factors into strategic asset allocation frameworks, investors can engage in sound risk management practices and identify economic shift with significant long-term growth potential.

Investors are traditionally accustomed to considering risk and return as the primary dimensions that inform their asset allocation decisions.

I would argue for the inclusion of a third dimension around sustainability becomes an input for portfolio construction.

The Big Interview: Impax CEO on avoiding 'lazy' ESG acronym and doubling assets by 2030

This allows investors to optimise their portfolios by considering risk, return, and sustainability in a holistic manner.

Investors will then have to calibrate their active sustainability risk budget to a level that aligns with their comfort and risk tolerance.

If an investor is not interested in sustainability, the weight given to its active risk budget will be zero and the optimisation will be the traditional mean-variance framework.

If an investor has a greater interest in sustainability, the active risk allocated to sustainability in the objective function will be more significant and skew the allocation towards assets scoring higher on that perspective.

Investor will also need to ensure that the budget allocated to sustainability is really linked to sustainability.

Sustainability goes beyond simply overweighting or underweighting specific sectors that are or aren't exposed to environmental and social risks.

Underweighting exposure to energy or overweighting technology is a sectoral bet, vulnerable to the cyclical nature of those industries.

Financial firms risk harming net zero ambitions by overlooking nature in decision making

As an investor, an approach that quantifies sectoral and geographical biases separately, while actively managing risks derived from sustainability considerations.

Allocating a sustainability budget then becomes comparable to active stock picking, aiming to construct a portfolio composed of top-performing companies in each sector while underweighting laggards.

This strategy aligns with sustainability goals and mitigates sector-geographic specific risks and biases.

Furthermore, this selectivity can lead to a neutral trade-off in risk-adjusted performance.

This has been backed by multitude of data analysis over the last 20 years, measuring the relationship between risk, return and sustainability.

What about short term risk and performance?

There are still many uncertainties and challenges regarding the short-term performance of sustainability considerations.

Although climate risk, biodiversity loss, and social inequalities pose fundamental risks to our economy, the market does not consistently reward or adequately account yet for these risks.

Price discovery related to these factors often lacks consistency.

Personally, I do not subscribe to the notion that investing sustainably always guarantees outperformance.

Sustainability consideration can influence investment outcomes, but its relationship with returns is complex and can vary across market conditions.

ESG is not a risk premium that investors can consistently harvest for higher returns although it remains my belief that sustainable investing will eventually provide such benefits at some point in time.

Under the assumption of market efficiency, we can envision a future where sustainability becomes the standard, and investors adequately factor in the risks associated with non-compliance with environmental and social factors.

In such a context, sustainable companies may no longer face active risk in the long term as the market appropriately prices sustainability risks.

Green bonds hit record fundraise while lending and M&A sink

The situation presents a dilemma for investors: how to determine an acceptable risk budget in the short term while anticipating future market shifts?

The transition period between the current stage, where investors and firms are mindful of ESG risks, and the equilibrium stage, where the impact of ESG is fully discounted, is significantly longer than the tactical asset allocation horizon but shorter than the long-term time frame for strategic asset allocation.

If we take climate risk, over a long-term horizon, companies and countries should become aligned with the net zero goal or have an expected return attached to the risk of not being so. But when is that?

The most common target among developed economies for a shift to net zero carbon emissions is 2050, with intermediate objectives for 2030. Since financial markets tend to front-run the economy, we could imagine the transition period in market performance to last a maximum of ten to 15 years.

Just as financial markets evolve, so asset allocation needs to evolve.

Although sustainable return cannot be guaranteed on the short-term, there is an expectation that they will eventually contribute to outperformance on the long-term.

In incorporating sustainability as an input of strategic asset allocation, investors can develop a more robust long-term solution, equipped to deal with short term deviance like the one we experienced in 2022.

To paraphrase Gandalf's in the *The Fellowship of the Ring*, we will have decided what to do with the time (and resources!) that are given us.

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