TIFF INSIGHTS

TIFF THOUGHT LEADERSHIP

On Sustainable Investing

Chris Matteini and Jay Willoughby – Winter 2019/2020

Chris Matteini (senior investment pro at TIFF[1]) and I were talking about the state of sustainability the other day, and now seems like a good time to share our view on where markets and investors are on the topic today. To start, investor confusion around the terminology and why we should care seems to be ebbing. Yes, sustainability is still defined and perceived in myriad ways, but what it boils down to largely is the efficient use of resources. Any system—a company, an industry, a market, an ecosystem—requires resources to survive. To the extent those resources are harmed or depleted, the survival of that system is at risk. To the extent those resources are maintained or renewed over time, that system has what it needs to sustain itself at least and potentially even thrive. The sustainability movement is a call for change in how we manage our resources, in particular our environmental, human and social resources. Thoughtless exploitation of those resources can work for some period of time and for some portion of the population, but in the end that approach is unsustainable.

Sustainable investing is an extension of this concept. The basic idea is to invest in businesses that employ best practices around the use of all forms of capital: financial, environmental, human, and social. Those businesses possess the best chance not just to survive, but to thrive. And of course sustainable investing also means avoiding businesses with high costs and headline risks due to poor governance and exploitative behaviors. Such behaviors are less and less tolerated by consumers, governments, and regulators. Increasingly, these behaviors make them less attractive to investors, too.

Sounds simple? Not so fast. While the high-level view is becoming easier to articulate, the details about what is most important, how to compare one business to another on environmental, social, and governance (ESG) factors, and how best to measure a single company's progress in improving its ESG footprint is as complicated as ever. Understanding these complexities and managing an investment portfolio to minimize ESG-related risks without sacrificing performance goals can be even more complicated, due in part to the myriad investment strategies that claim to fall under the "sustainable investments" umbrella. At TIFF, we have researched these strategies in depth and created a process for evaluating them (documents are available upon request). Let us now walk you through some of the tougher challenges investors face today as they seek to make their portfolios more sustainable. The investment world is making progress on these challenges, but as you'll see it's not yet an easy knot to untie.

The first critical issue is data. Corporate disclosure of ESG information is on the rise, but disclosure is not yet standardized. Groups like the Sustainability Accounting Standards Board (SASB)[2] have made significant progress to this end. The SASB standards were codified in 2019 following a multi-year process. The Task Force on Climate-Related Financial Disclosures (TCFD) has been a similar driver of improved disclosures in Europe, creating its own framework for ESG disclosure that is going to become mandatory for UNPRI signatories starting in 2020. Groups like CDP (formerly the Carbon Disclosure Project) and TruCost continue to grow their databases of ESG information and their services for helping corporations report. In the meantime, however, corporations remain hesitant, in part because disclosure is not yet a regulatory requirement, and there are no uniform standards for how to report. Further, there is concern among corporations that they may be documenting something today that haunts them in the future, and they have multiple constituencies asking them to report on dozens or even hundreds of different things. The picture is further complicated by the fact that different ESG rating agencies, those groups that score businesses based

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on their ESG profiles, can often generate significantly different scores for the same company due to the application of different methodologies. Standardization of disclosure practices will be a critical step for capital markets. We are inching closer, but we are not there yet.

How exactly to measure and report on ESG factors remains a question. In the meantime, industries and markets are changing due to sustainability-related risks and opportunities. Disruption is occurring. Renewable energy is now cheaper than fossil fuels in certain geographies. Nearly every auto manufacturer is slated to release electric models within the next few years. Innovations in agriculture are leading to dramatic reductions in water intensity in the context of increasing global temperatures and water scarcity. Hamburgers are now made from plants, a response to livestock farming being identified as one of the most carbon emission-intensive industries on the planet. Consumers are demanding greener products, from food to cosmetics to clothing. These changes are all the result of increased awareness of the side effects of inefficient use of resources, effects that include climate change, pollution, and social inequity. A recent United Nations Environment Programme report stated that limiting global temperature increases to 1.5 degrees above pre-industrial levels will require that global greenhouse gas (GHG) emissions peak in 2020. Emissions are currently estimated to peak at some point beyond 2030. Progress is being made: the percentage of global GHG emissions subject to carbon pricing regimes increased from roughly 5% in 2004 to just under 15% today.[3] Many believe that the percentage needs to be much higher. And of course, sustainability is not just about managing environmental resources. Human and social capital issues are also increasingly prominent, issues like gender pay gaps, board diversity, personal data security, income inequality, and the general impact that corporations have on the communities in which they are located and do business.

So, where do we think this leaves investors attempting to achieve performance targets while also making their portfolios more sustainable? We see both risk and opportunity. In managing risk, you need to understand your exposure to disruption, changing regulation, climate change, and consumer trends. ESG data and reporting may be spotty, but enough ESG information is now available to make it a valuable piece of the mosaic for those willing to do the work. The fact that ESG information is not yet standardized, and the resulting inefficiencies, actually make it possible to generate a competitive advantage through thoughtful ESG analysis. At TIFF, we take pains to understand how our managers evaluate ESG risks. We want to know that they are investing in businesses that use resources efficiently and are thus poised to thrive long-term. We believe this is simply sound investing. Capitalizing on opportunities created by sustainability-related disruption is just as important as managing risk. We want to be on the right side of secular change. We strive to allocate our members' capital to innovative managers and businesses that are altering industries by solving the critical problems of our time. It's not obvious or easy to identify those companies or managers that will be tomorrow's top sustainable investments or investors. But, working thoughtfully and methodically to identify and partner with those organizations today is the path to beating the market while also making a positive impact.

[3] Generation Investment Management Sustainability Trends Report 2018

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