Transitioning Towards a Sustainable Economy

Stockholm (HedgeNordic) – There are different opinions about the speed, strength and persistence of the economic recovery, but very few economists entertain the possibility of an end to economic growth. “We are one of very few financial institutions who even talk about the possibility of less economic growth or zero economic growth. Impact and sustainability have to come first and it is currently very hard to grow the economy within our planetary boundaries, based on current technology. John Kerry recently said that the US pledge depended on about 50% unproven technology. We are therefore agnostic on what economic growth outcome turns out to be consistent with sustainable impact investing, and the outcome might even be negative growth if technology does not progress enough,” says Hans Stegeman, Chief Investment Strategist at Triodos Investment Management, which runs EUR 5.4 billion in impact investing strategies in public and private markets, all of which are expected to be classified as “Article 9” or “dark green” under SFDR.

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The pathway of sustainable growth is difficult to predict partly because governments and companies are still a long way from the right policies. There were high hopes that the Covid crisis would lead to a reset towards greener economics but this has been disappointing. Of course, the lockdowns produced a temporary reduction in carbon emissions, but the Covid rescue and stimulus was more backward looking than forward looking. “Most of the government intervention and public spending was saving the old economy such as airlines and other unsustainable industries. Only a tiny part was spent on the broader agenda of the real reset. Voters are expressing a preference for more radical change in a few countries such as New Zealand, Scotland, and Finland, but in general policy has not moved the economy to a sustainable path. It is true that governments and companies are making announcements about targets for the UN Sustainable Development Goals (SDGs). However, in many cases that are just re-labelling and reporting what they already do, and not making additional commitments,” explains Stegeman.

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Covid has also had adverse effects by delaying the probable timeline for achieving the SDGs. “For instance, the pandemic has increased inequality between and within countries, which makes it more difficult to attain the goal of financial inclusion,” says Stegeman.

Where policy has radically changed is the size of monetary and fiscal stimulus, which has been far greater than after the great financial crisis. This, combined with economies adapting to the lockdowns, has made them more resilient at least in the short term: “advanced economies are in good shape with relatively low unemployment. For the first time in many years, we see some risk of higher inflation. Part of this is a temporary response to supply chains and commodity prices, but we also see a risk of longer term – if not permanent – inflation, partly because central banks now have a broader mandate beyond price stability. Short term we see a roaring 2021 with pent up spending demand boosting growth and inflation. Longer term, we still see low structural productivity growth and high debt keeping structural economic growth lower".

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Private Markets

With government debt and corporate leverage already high, private debt can complement public or private equity as a way to raise funds for instance through green bonds or social bonds. Private equity firms have over two trillion dollars of dry powder, which can be used to encourage firms to transition their business models. There are far more private than public companies: "in 2019 alone, European private equity investment was directed to about 7,900 companies, 84% of which were SMEs," says Triodos IM paper, "Investing in Radical Change". Companies that are too small for public markets could be needed to access small scale local food production, distribution and recycling solutions.

There will be different levels of risk appetite at each stage of transition, requiring different forms of funding. For instance, "private capital is also often needed to provide project finance, for projects such as solar panels, solar parks and wind parks," says Stegeman.

Reforestation, Nature-Based Solutions and Biodiversity

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Searching for transition solutions has led Triodos IM to innovative, flexible and open-minded private companies. "Private companies will play an important role in reforestation, and nature-based solutions. We also find that smaller companies are more open to dialogue around the social and ecological impact of their activities. In contrast, shareholders are trying to make Shell more sustainable for the fifth time. Private companies can also be more innovative, in areas such as energy, agriculture and food. It is almost impossible to currently find companies that help biodiversity on a large scale," says Stegeman.

Holistic Impact Investing

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Investing across public and private markets maximises the opportunities for addressing different dimensions of impact, through companies of all sizes, in different geographies including emerging and frontier markets that often lack developed public capital markets. Investors need to look at sustainability holistically from many frameworks. "we do not want to single out one or a few of the UN SDGs, because they are all interconnected. Most investors are reductionists but they need to see the big picture. Solar panel projects have their own lifecycle of emissions. Microfinance, which promotes financial inclusion, could have an impact on climate change."

Beyond Climate

For instance, environmental concerns only start with climate: “carbon is a relatively easy topic to calculate budgets for and mitigate. Biodiversity is much more complex in terms of measuring costs, damage, tipping points. Therefore, we exclude companies that contribute to loss of biodiversity through activities such as deforestation or producing palm oil. We also engage with companies on deforestation and reforestation, though this is also difficult. Longer term we expect companies to be more transparent about what they do with offsets, as a basis for building a bigger market for investing in biodiversity solutions. A lot of capital could be spent on that, restructuring and rebuilding to make returns.”

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The first phase of the EU taxonomy is arguably too climate-centric in focusing on the first two of the six environmental objectives: climate adaptation and climate mitigation. “We are explaining to clients that our vision of sustainability is broader than the current EU taxonomy, and we would like to see the taxonomy broadened out. This would also encourage more transparent company reporting. Our discussions with the EU are focused on more transparency, including disclosure of unsustainable activities that should be phased out,” says Stegeman. Eventually, the next four environmental objectives should be added to the taxonomy: sustainable use of water and marine sources; circular economy; pollution prevention, and healthy ecosystem, which includes biodiversity.

Forward-Looking Benchmarking

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Benchmarking is another area of focus for regulators. Even within a climate-centric framework, non-financial benchmarking and reporting needs to become more forward-looking: “it is not sufficient for asset managers to say their fund has lower carbon emissions than a benchmark, because this is relative and backward looking. Beating a benchmark is not enough when the world is unsustainable – we need to think in absolute terms. We also need to use forward looking measures, compared to the Paris agreement targets out to 2050,” says Stegeman.

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