Capital responds to climate change despite wavering at Davos

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According to widely accepted climate models, rampant Greenhouse gas (GHG) emissions are causing global mean temperatures to rise. This is resulting in heavy and erratic precipitation patterns, increased probability of droughts, sea level rise, and ecosystem disruption, among other impacts. In fact, the World Economic Forum's 2020 Global Risk Report identifies extreme weather and climate inaction as top risks in terms of both likelihood and impact.[1] These changes to the global climate present severe risks to human health, livelihoods, resource supply, security, and economic growth.[2] In fact, some credible economic forecasts predict that unconstrained emissions would strip 30 percent off the world economy by 2100.[3] The World Economic Forum's annual meeting in Davos this month exemplifies how climate is finally being addressed as more than a marginal topic by major economic institutions.

Many are skeptical of any material progress that Davos might instigate, as governments can be slow to react, and countries with the largest GHG emissions have shown themselves to be the least motivated to reduce reliance on carbon fuels. While the summit at Davos crystallized the significance of climate change for the economy at the highest levels, no concrete solution or policy resulted from the conference.

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Despite the lack of action, it is important to note that sovereign governments and large forums are not the only vectors for change. Financial institutions and capital providers can also be highly influential in directing capital towards activities that mitigate climate change and away from those that exacerbate it. Partly at the behest of activist investors, employees, and clients, many companies are already adapting their strategies to incorporate climate risks, based on the expectation that climate change will impact their business models in the near rather than distant future. This approach remains a controversial investment differentiator, since many investors feel that incorporating an assessment of climate resilience in their investment decisions goes beyond their mandate, not wanting to be the ones to "referee winners and losers." Nevertheless, many forward-looking investors, ourselves among them, are confident that proactive management of climate risk will be a differentiating performance factor in investment outcomes for the decades to come.

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Research and data substantiate our views. Park & Monk (2019) find that carbon efficiency, as a proxy for GHG emission intensity, has a positive link with financial performance, especially since 2010.[4] Hunt, Chelsie and Weber (2018) find that firms that shift their assets from carbon intensive investments to non-carbon counterparts obtain higher profitability.[5] In fact, by incorporating the cost of carbon risk into returns, low-carbon portfolios can outperform their peers.[6]

From our perspective, the investment industry as a whole has long mispriced "non-financial" risks, as ESG factors are often called, especially when it comes to climate risk. At a minimum, the Davos conference this year amplifies the sense of urgency around climate change, which should lead to significant improvement in corporate reporting on climate risk mitigation and management. This in turn should lead to investor consensus on climate-related metrics and factors to incorporate into investment decision-making. We believe that the gradual incorporation of ESG metrics by most investors over time allows "early adopters" to benefit most from the returns generated by companies who proactively incorporate climate risk into their business models.

The early stages of investing with a climate resilience lens are focused on seeking out companies who disclose climate risks and strategies for mitigation/adaptation. But disclosure alone is only the first step and must quickly be followed by measurable action. As the data show, performance matters[7]. We expect investment performance and strategic climate resilience to be closely correlated going forward, as more abundant and consistent reporting across sectors and geographies help investors attribute the impact of climate resilience factors on investment returns.

It is fitting that this year's theme at Davos was "**better capitalism**." This theme places the focus on capital allocation as the mechanism to address climate change, and will push investors to incorporate previously uncalculated risks into portfolios. The rapid market recalibration in the face of climate urgency presents the opportunity to deliver superior risk-adjusted returns, and to direct capital intentionally towards activities that mitigate climate risk.

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3. Burke, Marshall and Vincent Tanutama (2019) "Climatic constraints on aggregate economic output" NBER Working Paper 25779, doi 10.3386/w25779
4. In, Park & Monk. "Is 'Being Green' Rewarded in the Market?: An empirical investigation of Decarbonization and Stock Returns," 2019
5. Hunt, Chelsie, and Olaf Weber. 2018. "Fossil Fuel Divestment Strategies: Financial and Carbon Related Consequences." Organization & Environment 1–21. doi:10.1177/1086026618773985
6. Samama, Bolton and Andersson (2016). Hedging Climate Risk. Financial Analysts Journal
7. Goldman Sachs Global Investment Research, comp., GS Sustain: Alpha in Global Quality (n.p.: Goldman Sachs, 2020), 26-30.