PRINCIPLES OF SUSTAINABLE FINANCE

Chapter 7: Investing for long-term value creation

Overview of the book

Part I: What is sustainability and why does it matter?

1. Sustainability and the transition challenge

Part II: Sustainability's challenges to corporates

2. Externalities - internalisation
3. Governance and behaviour
4. Coalitions for sustainable finance
5. Strategy and intangibles – changing business models
6. Integrated reporting - metrics and data

Part III: Financing sustainability

7. **Investing for long-term value creation**
8. Equity – investing with an ownership stake
9. Bonds – investing without voting power
10. Banks – new forms of lending
11. Insurance – managing long-term risk

Part IV: Epilogue

12. Transition management and integrated thinking

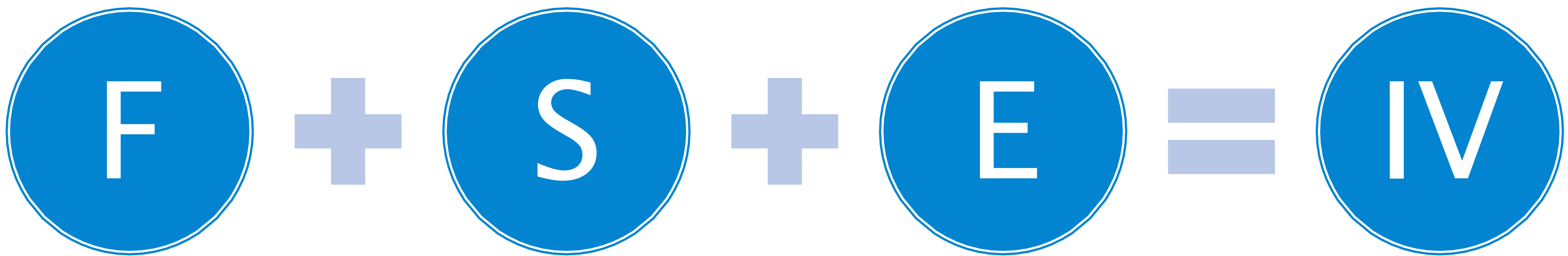
Learning objectives – chapter 7

- explain why the financial system needs to adapt
- discuss what the obstacles to adaptation are and how they can be overcome
- explain the key differences between active and passive investment approaches
- identify the different parties in the investment chain
- list and understand the conditions for long-term value creation by investors
- contrast traditional performance measures with alternative ones

Why invest for long-term value?
And how?

LTVC

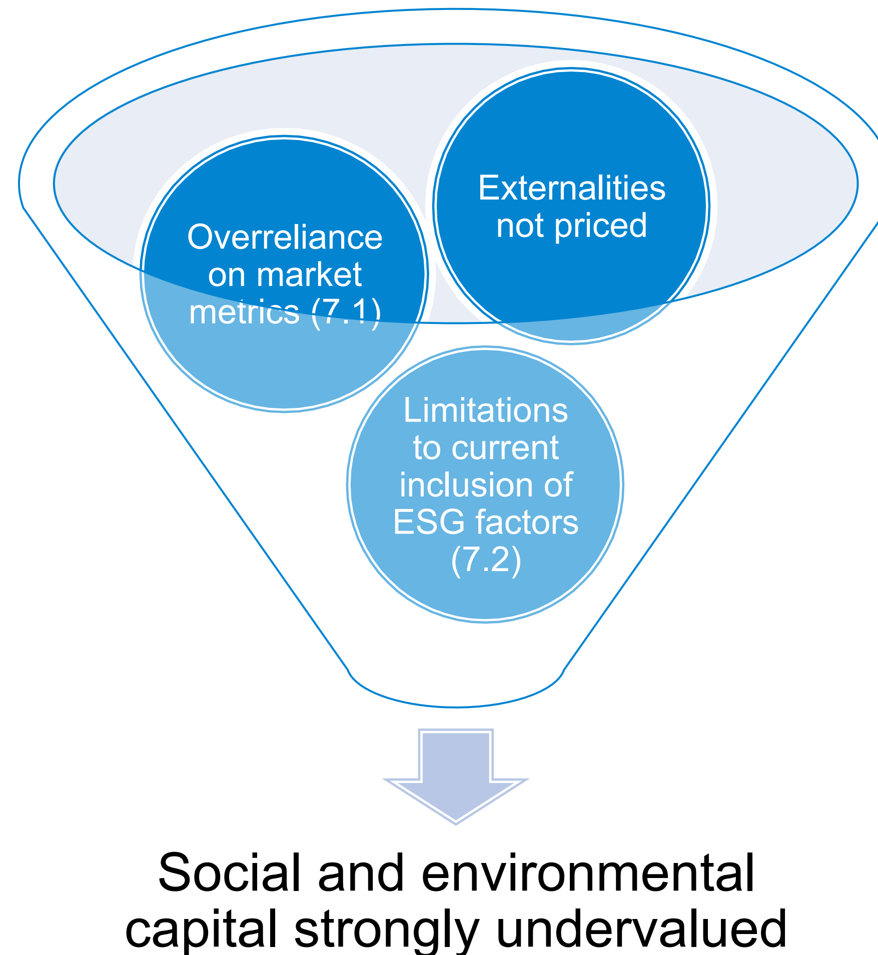
To optimise financial, social and environmental value subject to risk



Traditional versus long-term investing

Dimension	Traditional investing	Long-term value creation
Typology	Sustainable Finance 1.0	Sustainable Finance 2.0
Market framework used	Efficient Markets Hypothesis	Adaptive Markets Hypothesis
Pricing of social (S) and environmental (E) dimension	Irrelevant or already priced in	Priced as market participants learn
Value maximisation	**Max F**	**Max IV = F + S + E**
Value indicator	Earnings per Share (EPS)	Sophisticated DCF with scenarios for internalisation
Investment chains	Long and complicated	Short and simple
Portfolios	Extremely diversified	More concentrated
Dialogues with corporates	Limited	Deep
Performance horizon	12 months	Years or decade

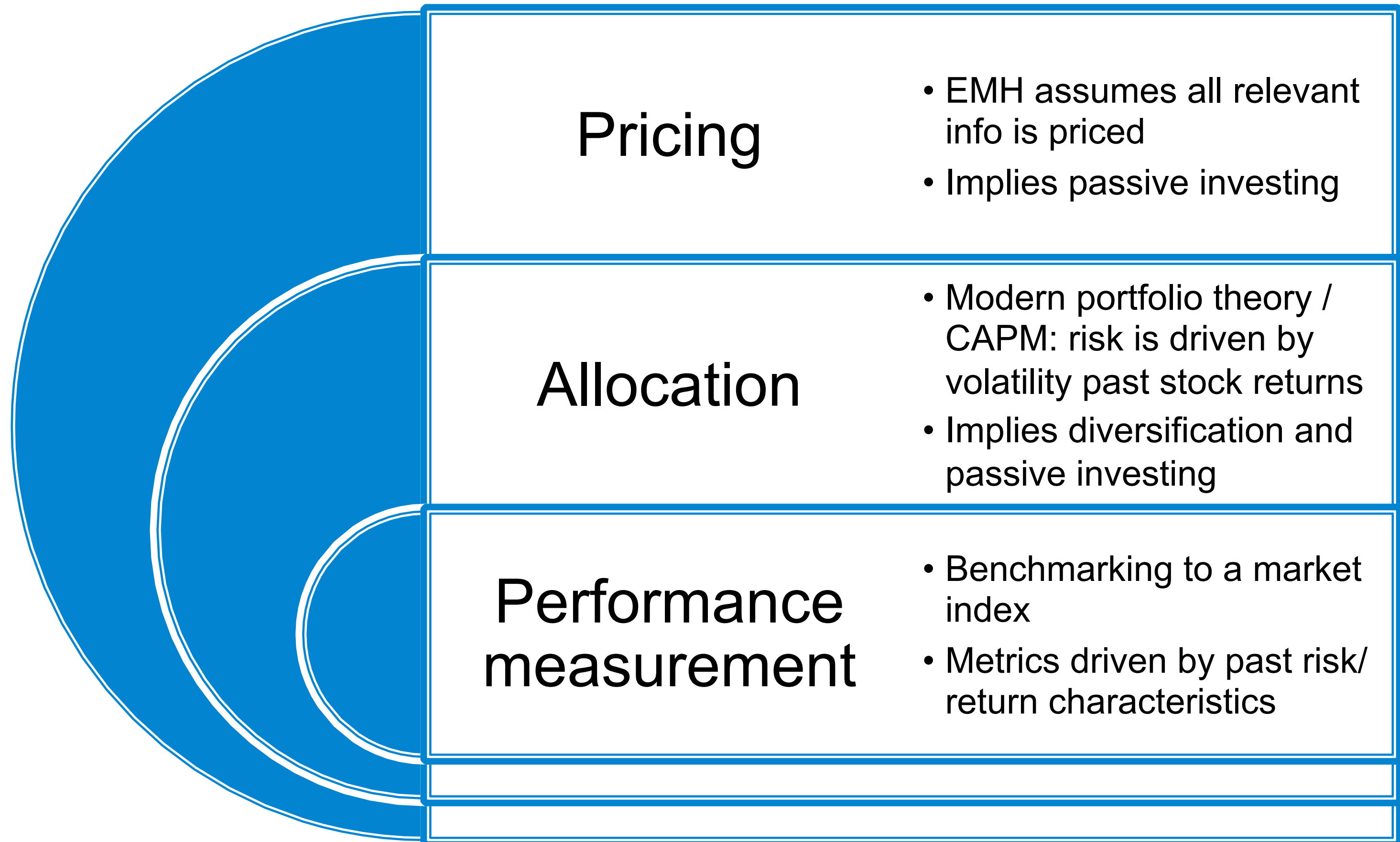
The current financial system fails to achieve societal goals



Overreliance on market metrics

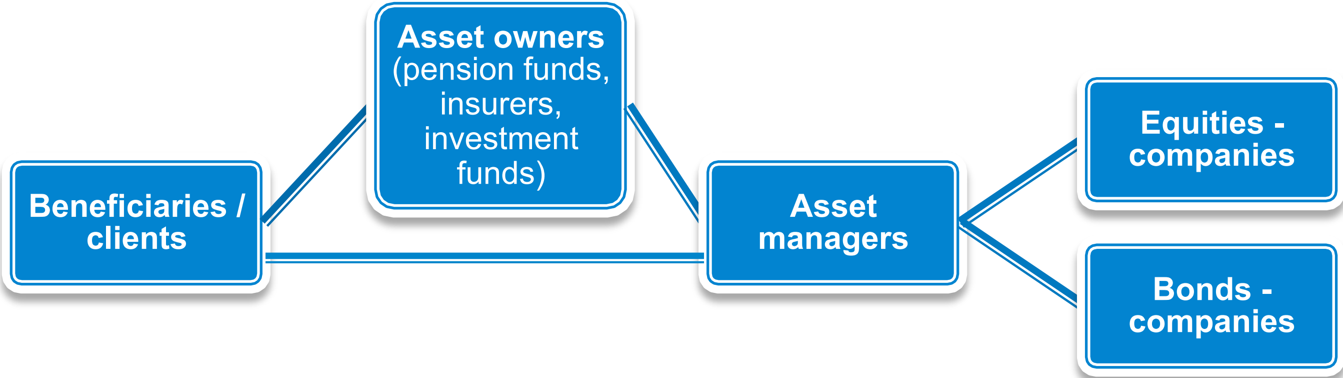
Current investment practices have no role for E and S: unrealistic in a full world

- Busted by behavioural & sustainability anomalies
- But still dominates communication & thinking

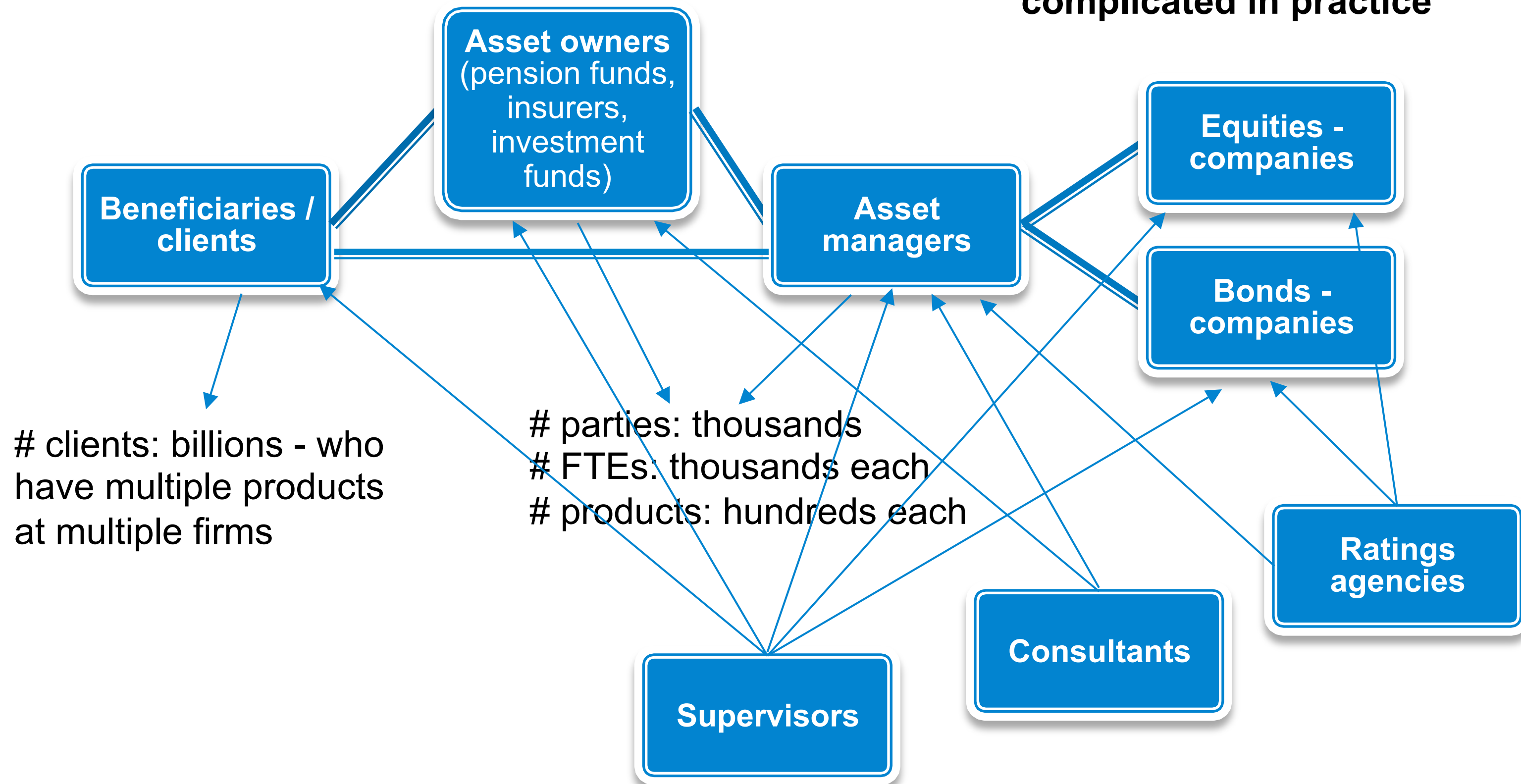


Long & complicated investment chains

Figure 7.1: A stylised investment chain. It looks simple..



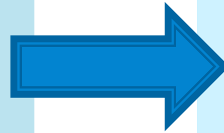
Long & complicated investment chains



Along the chain, a lot of valuable information is lost

Limitations to approaches for inclusion of ESG factors

ESG tools:
- ESG ratings
- ESG indices



Problem 1: they are add-ons that do not address core issues

Problem 2: Design limitations
- Limited focus on materiality
- Based on reported data & policies only
- Industry neutral
- Focused on operations, not products

More problems:
- Bias to large companies
- Intuitively wrong scores
- Failure to spot material weaknesses

Solving it with an active investing approach

- Pricing: from EMH to AMH
- Allocation 1) from ESG factors to fundamental ESG analysis
- Allocation 2) from extremely diversified to more concentrated portfolios
- Engagement
- Alternative measures of performance
- Simpler investment chains

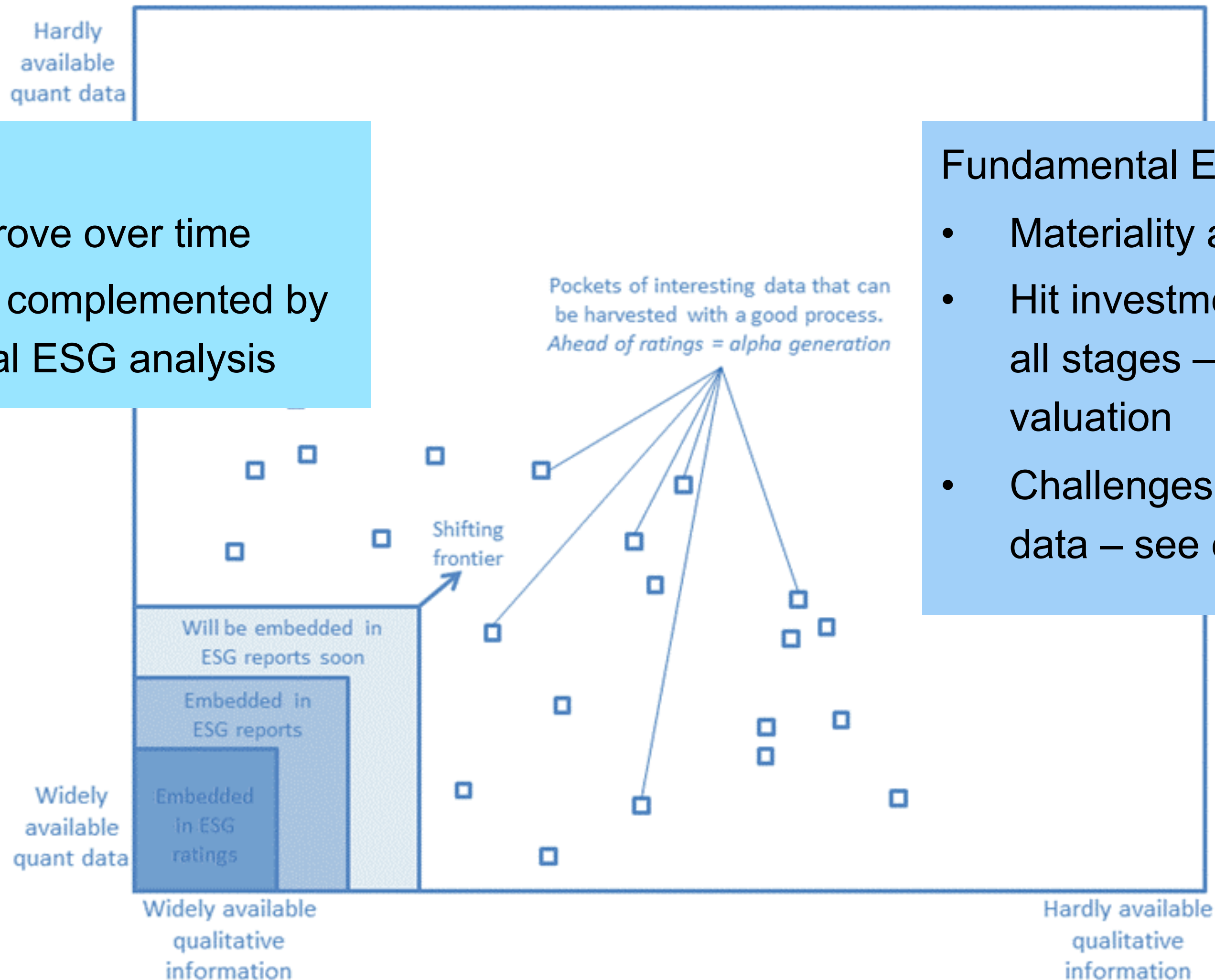
Pricing: from EMH to AMH

EMH	AMH
Instantaneous incorporation of all relevant information	Degree of market efficiency depends on market ecology
All ESG information is either irrelevant or already priced	Pricing of ESG information depends on the number and quality of market participants that take ESG seriously
Unrealistic	Plausible

Allocation 1): from ESG factors to fundamental ESG analysis

ESG factors

- should improve over time
- Need to be complemented by fundamental ESG analysis



Fundamental ESG analysis:

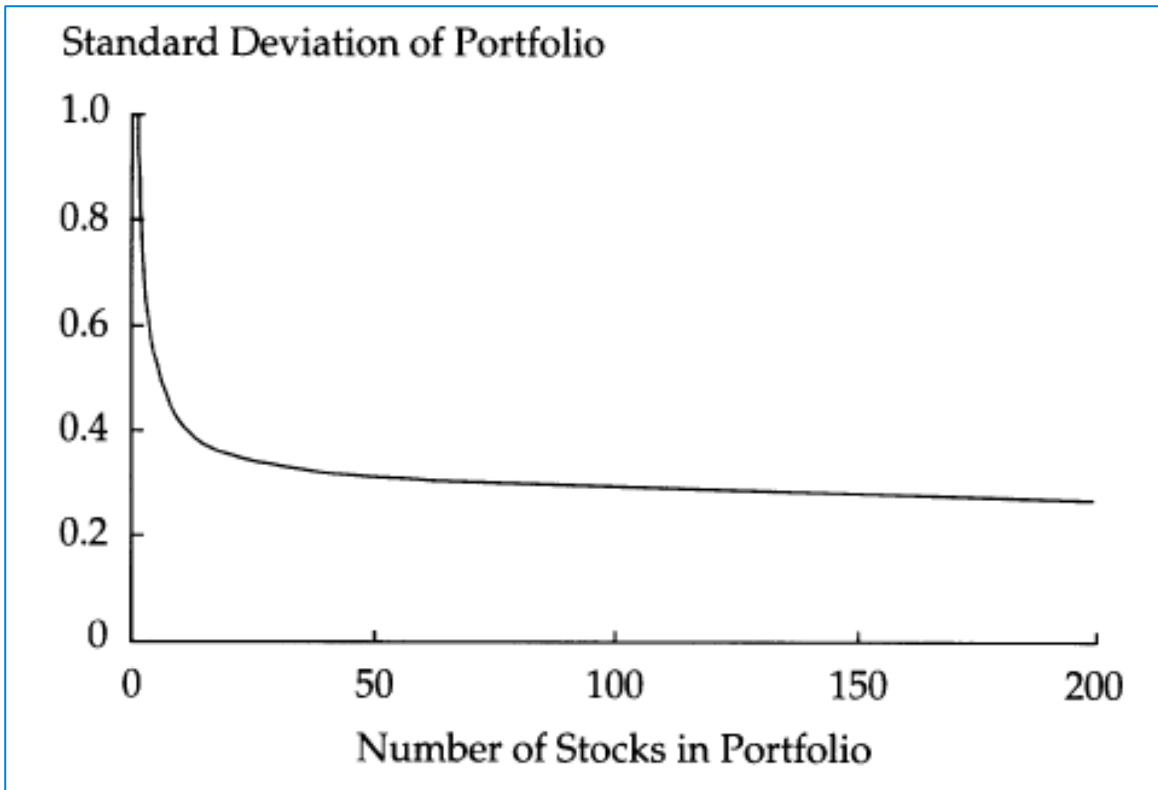
- Materiality assessment
- Hit investment process in all stages – including valuation
- Challenges: mindsets and data – see chapter 8

Allocation 2) from extremely diversified to more concentrated portfolios

Pension funds may hold thousands of different securities

Serious engagement not feasible…

… While not necessary from a diversification perspective….



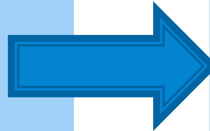
Engagement

Investors and corporates to exchange funds & ideas:

- Pressure to end unsustainable practices
- Improve reporting
- Share best practices

Engagement is costly:

- Time intense
- Requires deep knowledge, patience & coordination



Engagement in practice:

- Not feasible for large portfolios
- Shallow (disconnected from investment case) and/or narrow: voting, not dialogue

Ideally:

- Integrated process from analysis and selection to engagement
- Integrated teams for portfolio management and engagement

Alternative measures of performance

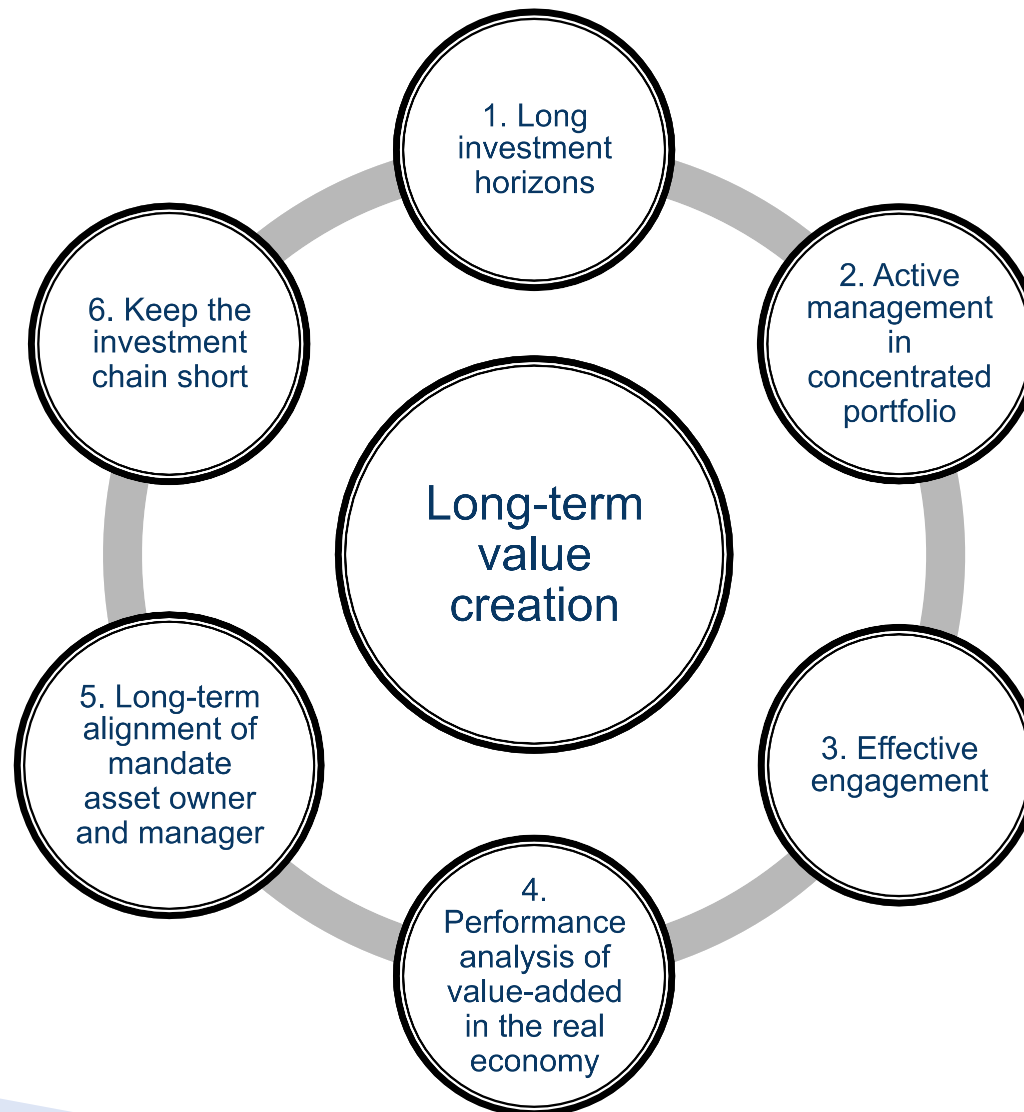
Alternative **financial** performance metrics

- Versus peers & groups of indices
- Absolute return

Non-financial performance metrics

- Performance on specific KPIs
- Externality valuation frameworks
- Contribution to global sustainability goals

Conditions for LTVC



Conclusions

- LTVC requires moving from maximising financial value to integrated value
- Obstacles are the overreliance on market metrics and complex investment chains