Environmental Finance

Institutional portfolios can be more resilient with Impact

Channels: IMPACT

Companies: Earth Capital

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04 June 2020

The unexpected stress test of Covid-19 has provided insight into which companies might be more resilient to risks such as climate change, according to **Gordon Power**

Covid-19 is having an unprecedented impact on markets. In a career spanning fifty years, and having been in the private equity world for some thirty-five years, I have seen the ups and downs of economic cycles and some startling market events. Covid-19 is a harsh reminder of the precarious nature of our financial markets and their fragility to major global threats when these threats are ignored.

Meanwhile, the strain on the planet's resources and carbon dioxide emissions continue to get worse, and social inequality has reached a critical point – made even more severe by the devastating pandemic we're living through. These issues are just as urgent as they were before Covid-19 struck, and – as with Covid-19 – they are a threat to us and our ecosystems.

The main concern paralysing the financial markets right now is uncertainty. Investors and the business community are questioning how long this crisis will last, and when consumer and investor confidence will return, even with the end to lockdown looking imminent. But while none of us can predict the future, when some form of 'normal life' does return, one possible outcome is that the crisis will cause an unprecedented shift in capital — potentially for the better. Why? Because this coronavirus is a relatively short-term test of which companies will be most resilient to another global and longer-term crisis: climate change.

Gordon Power

Therefore the big challenge for institutional asset owners over this next decade is to build resilient portfolios that hold the type of companies that can better navigate the diverse investment landscapes where the destabilisation of our global systems is not as marked – such as we have seen in Covid-19-hit markets.

Institutional asset owners and their advisers, foundations and endowments, pension schemes, trustees and consultants, all have a responsibility to consider how best to make their investments sustainable and resilient to future challenges. And there is legislative pressure to change too, including in the form of the revised UK Stewardship Code, which places ESG factors and climate change at the heart of effective stewardship.[1]

Is impact investment the answer to building more resilient portfolios?

The rocky public markets have been making the headlines, but the impact investment market, on the contrary, has been steady. Insofar as it concerns the public markets, sustainable funds appear to have been more resilient than their more conventional fund peers, according to MSCI. Once viewed with suspicion, funds with a sustainability mandate have proved their mettle, and have outperformed other funds during this crisis. This could be the prompt that investors have been waiting for – and could see greater preference for sustainable funds.

The picture may look even more robust in the private markets, among investors that specialise in sustainable investing. A small percentage of Earth Capital's portfolio (which has a sole focus on sustainable private investments across the themes of water, food and energy) has been negatively impacted on a fundamental basis (i.e. sales, cash flow etc) – a situation which is relatively at odds with general investment consensus – and the rest of our investments continue to weather the storm.

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As environmental disasters, dramatic shifts in energy markets, and legislative changes emerge, those funds that have absorbed the Covid-19 shock are more likely to demonstrate their resilience once again. Companies are sensitive to market signals, and as investors move to resilient low-carbon alternatives, all businesses will be forced down the same route regardless of size or sector.

Indeed, transitioning to a low-carbon economy means dealing with growing physical risks such as extreme weather events and investing sustainably today will help to avoid future risk scenarios developing. Covid-19 has exposed dependency on fossil fuel-intensive companies and is providing an unexpected stress test, enabling us to see how prepared they – and, indeed, all companies – may be for the climate change shocks that are on the horizon.

Making a positive impact for the future

Impact investing is more important, and prevalent than ever. The pandemic has shown us that high probability/high impact risks must be acted upon in a timely fashion. We call on trustees and other institutional investors to seize the moment and collaborate effectively.

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There is an opportunity to drive major changes in the financial system, and asset owning decision-makers such as pension trustees have a crucial role in driving this. The way we tackle the recovery phase will shape whether we're moving to a new global economic order with positive impact at its centre. Many family offices, endowments and fiduciary managers appear to be taking note, with a discernible shift toward ESG, sustainable and impact-driven investment strategies following the pandemic's peak; most likely in a bid to better manage future volatility in the event of natural shocks like Covid-19.

The clock is ticking to address the climate crisis. The required technology and awareness for change is already here but we now need this change to become reality and Covid-19 could be the wake-up call. When this devastating crisis is over, we can only hope that the world has learned the lessons necessary to ensure that our future is more sustainable and more secure.

Gordon Power is chief investment officer of London-based private equity firm Earth Capital

[1]. https://www.burges-salmon.com/news-and-insight/legal-updates/corporate/esg-and-the-uk-stewardship-code-2020/