Closing Thought

By Steve Waygood

The signs are all there. Swedish climate campaigner Greta Thunberg has inspired children around the world to make their voices heard and the rising tide of Extinction Rebellion shows that people clearly care. People are starting to realise that we are part of the problem; how we vote, spend, save and invest have far-reaching consequences.

For all the progress during 2018, it is worth noting that the financial system is still not on a sustainable footing. We are not, as the Brundtland definition would have it, meeting the needs of the present without harming the ability of future generations to meet their own needs.

There are a range of reasons for this, but the short-termism inherent within market valuation techniques stands out. Discounted Cash Flow (DCF) underpins fundamental analysis. But DCF ignores social capital as it is external to the corporate profit and loss statement. DCF essentially ignores future generations with its discount rates and assumes away the need to preserve natural capital by assuming all investments can grow infinitely.

The result is thousands of professional investors, managing trillions of assets on behalf of others, who all largely ignore the one planet boundary condition. It is primarily the role of governments to correct market failures – for example, by ensuring natural and social capital is properly priced and that corporations pay the full price for the goods and services they consume. Fiscal measures such as carbon taxes, market mechanisms like emissions trading schemes, and standards and regulations are vital to sustainable development. They help ensure that the market price reflects the full social and environmental costs, which in turn drives corporate valuation.

Our financial services system has a responsibility to serve society and the real economy. But complexity clouds matters. Very few policy makers, politicians or civil society representatives understand how the many different financial services institutions work together to finance the world we live in today and will retire into tomorrow. In the absence of appropriate oversight, society and the real economy often serve financial interests, rather than the other way around.

As investors, we need to be strategically clear about where our own spheres of responsibility begin and end. While we have a fiduciary duty to exploit market inefficiencies to generate alpha in our investment decisions, we also have a duty to behave as good owners – or stewards – of the businesses we own. With the scale of the challenges that society is now confronting, we believe that our stewardship now needs to extend to reforming the system itself.

And while we cannot be expected to correct market failures on our own, we know that we can make a difference and understand the power of creating change from within. This is why we spend so much of our time on market reform. In the presence of market failure, integration of ESG into investment analysis motivates the wrong behaviours, and engagement with companies is doomed to fail as one is essentially asking the company to go against the market incentives and lose money.

If the economy is to be moved onto a truly sustainable basis, then we would expect to see governments acting to correct the many distortions in the pricing systems on fisheries, freshwater, climate change and natural resource depletion. This is how sustainability issues become relevant to corporate valuations, and this is how capital can be put to work in the right places. Setting standards, creating fiscal measures such as carbon taxes, or setting up market mechanisms such as carbon trading schemes that price the externalities are a good start, but far more is required.

So when will capitalism become sustainable? It will be when institutional investors and big business realise that their long-term survival is threatened by unsustainable business practices and stand up to challenge governments to correct these market failures. If we can move toward achieving that in 2019, then we will have really made a difference.