Clean investing: why do it?

the business case for being natural resource and environmentally savvy

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'Clean' investing what is it?

There are a number of possible definitions of the terms 'dirty' and 'clean investing'.

For some investors, 'dirty' and 'clean' investing may mean the distinction between investing in funds where each fee, charge, cost, expense and commission are all 'bundled' together into one single 'dirty' fee; or it could mean investing in funds where all these are 'unbundled' and are transparent to investors.

For other investors, 'dirty' and 'clean' investing might be taken as the distinction between knowingly investing in some 'dirty' listed companies that damage or pollute the natural environment, and only investing in listed 'clean' companies whose business is cleaning up the environment.

As virtually every human activity has some negative or 'dirty' impact on some part of the earth, having a wider definition of 'clean' investing is far more helpful and appropriate for asset owners and asset managers.

I suggest 'clean' investing is about getting a good, risk adjusted, financial return and at the same time seeking to minimise, reduce, and mitigate negative environmental impacts, and where possible seeking to make an environmentally positive impacts on the thin surface layer of the planet we live in called the biosphere.

Clean investing why do it ?

There are a number of reasons why investors should adopt clean investing including risk avoidance, opportunity exploitation, sectoral and geographical portfolio diversification, capital preservation, and income generation.

The global population is rising, our natural resources are finite, and global climate change is already, and will increasingly impact on humanity. These are financially material risks to investors. Investors should aim to measure, monitor and continually reduce the negative environmental footprint of their investments.

Conversely the adoption of techniques to conserve and use earth's natural resources more efficiently so as to minimise negative or create positive environmental impacts on the planet are financially material opportunities for investors. Investors should aim to measure, monitor and increase their exposure to such investments.

For asset owners like pension funds with fiduciary duties towards their fund beneficiaries – clean investing should definitely be on their agenda. For example the socio-economic impacts of global warming leading to climate change are expected to significantly increase in the coming decades and this will impact on the lives of current and future pensioners.

This is a very compelling reason for pension funds who need to invest for the long term to take into account climate change impacts and opportunities in their statement of investment principles, investment beliefs and strategy, asset allocation, mandate design, fund manager selection, and performance monitoring.

Clean investing should not, and does not, need to involve any compromise to financial returns. It can and should over the long term deliver better returns than 'dirty' investments that have inherent financially significant and reputational risks.

Clean investing how to do it ?

There is now a diversity of ways to invest and develop a portfolio of 'clean' investments across a range of asset classes including the following:

- 'Green' bonds are available from some international financial institutions and banks that are at least as good as traditional government or corporate bonds.
- Public equity funds that specialise in investing in listed companies in single sectors like water or renewable energy, or across a range of environmental goods and services sectors.
- Private equity funds that specialise in the development and exploitation of clean technology for example in renewable energy generation and storage, or waste water treatment and purification.
- Real estate and property funds which revitalise disused or derelict "brownfield" land, and or are developing more material and energy efficient buildings, and or using internal environmental management systems to reduce energy, water, and waste.
- Infrastructure funds that invest in renewable energy facilities, combined heat and power plants, smart distribution grids, or waste collection, treatment and recycling facilities, flood defences, and mass transport metros and railways.
- Forestry or timberland businesses that practice sustainable silviculture who harvest trees in certified sustainable manner that also set aside sufficient land for higher and better uses to protect wildlife, enhance bio-diversity, and maintain environmental services.
- Farmland businesses that are eco-friendly who support and practice sustainable arable or pastoral farming and agricultural practices to certified standards that also protect natural habitats and demonstrate good environmental stewardship of land, soil, and water resources.

With respect to investment returns 'green' bonds can offer fixed income yields at least as good as traditional government or corporate bonds. The performance of thematic equity funds exhibit volatility if measured against traditional broad market indices. So their performance needs to be assessed against bespoke sectoral benchmarks.

Alternative investments (property, private equity, infrastructure, forestry and farmland) benefit from being tangible physical assets with medium to long-term risks that are lower than stock-market listed investments. They usually have identifiable and reliable annual cash flows (a portion of which would be either explicitly or implicitly inflation-linked) with average return expectations above inflation net of fees and costs which are attractive to long term investors like pension funds who may have inflation linked liabilities.

When it comes to implementing a 'clean' investment strategy, investors should also seek to adopt and implement internationally recognised ESG standards and best practice in each asset class. Some examples are given below and there are others in existence or under development by the UNPRI and other bodies.

- For property by utilising the Leadership in Energy and Environmental Design (LEED) standard, Global Real Estate Sustainability Benchmark (GRESB), the BRE Environmental Assessment Method (BREEAM), the UNEP Sustainable Buildings & Construction Initiative (UNEP SBCI) and UNEP Finance Initiative Property Working Group (UNEP FI PWG) toolkits.
- For infrastructure by using the Equator Principles which are based on the IFC Performance Standards and the World Bank Group Environmental, Health and Safety Guidelines for assessing and managing environmental and social risk in project finance transactions IFC Environmental, Health, and Safety (EHS) Guidelines and by use of the IFC Environmental, Health, and Safety (EHS) Guidelines.
- For farmland by using the UN Principles for Responsible Investment in Farmland, Roundtable for Sustainable Palm Oil (RSPO) principles, and Sustainable Agriculture Network (SAN) standards.
- For forestry by using the Forest Stewardship Council's (FSC) Principles and Criteria for forest management certification or the Sustainable Forestry Initiative (SFI) or the Programme for the Endorsement of Forest Certification (PEFC).

Some investors may want to avoid investments where they consider the environmental risks to be unacceptable, such as high carbon impact sectors (new coal power plants and airports), or high environmental impact investments (new oil pipelines, refineries, toxic chemical production facilities) or which involves 'land grab or forestry conversion' that might involve illegal logging in UNESCO World Heritage or Ramsar Convention sites or deforestation of high value primary forest or tropical hardwoods to grow crops unsuitable to local conditions.

'Clean' investing what future?

Setting aside the positive impact of any future international global climate deals (and lets hope there is one in Paris 2015) or individual government policy interventions to conserve or protect scarce natural resources (which is prudent); there are a number of drivers that would suggest 'clean' investing should be a successful strategy going forward.

These include the impact of

- global population growth, more urbanisation, better health care and ageing
- growing demand for food and energy and concerns over food and energy security,
- global warming, changing weather patterns and extremes, and climate change impacts,
- increasing consumer demand for more goods, products and services (that use or contain critical natural resources),
- ageing infrastructure in developed markets and under-developed infrastructure in developing market,
- implementation of environmental regulations to clean air, land, water and hazardous chemical and reduce waste

Arising from these important trends and societal concerns there are significant investment risks. For example continuing to invest in what may become un-burnable stranded hydrocarbon assets like coal, oil and gas reserves on traditional energy company balance sheets.

There are also a wide range of investment themes including for example renewables, resource efficiency, redesign, and reforestation that offer potential opportunities for environmentally savvy investors.

- Renewable energy – Solar and wind energy is at or approaching grid price parity with traditional energy sources, and through technological developments if we can develop natural geothermal or lunar (tidal) energy sources they could become very attractive low carbon investments and help reduce dependency on fossil fuels.
- Resource efficiency – Recycling of some raw or processed materials is already economically viable. There are further opportunities to scale up and improve the efficiency of resource recovery for a wider range of consumer products and society 'waste' materials, and even mine older landfills for very high value 'rare earth' metals.
- Redesign – Businesses need to rethink how valuable resources are "trapped" in numerous consumer products and modern technology and ensure when they come to the end of their life they can be re-used and easily transformed into a wide range of valuable potential secondary uses or new by-products in order to avoid wasting and land-filling natural resources. These secondary uses and up-cycling need to be included right up front at the very start of the original product design process and may offer new long term revenue streams.
- Reforestation – there are tracts of disused land that was once was natural forest and habitat for indigenous wildlife that has been felled for building materials or other uses and was never re-planted. In some localities reforestation would create income generating investment opportunities and benefit the environment and bio-diversity.

Going forward it makes sense for asset owners, asset managers, and business owners to be more natural resource and environmentally savvy. This needs to start at the top and be embedded in their organisational governance and when creating or re-setting their future investment and business strategies. Currently this is a lacunae in many organisations decision making machinery. Maybe time has come that this needs to change? ■

Further information: Howard Pearce is Director of HowEsg.co.uk that specialises in environmental strategy and governance solutions for asset owners, asset managers, corporate bodies, and charities. He is also a non-executive trustee of a public hospital charity and commercial harbour authority. He was formerly Head of Environmental Finance and Pension Fund Management for the UK Environment Agency 2003-13. In this period the Environment Agency Pension Fund (EAPF) won over 25 UK, EU, and global awards for the high quality of its governance, financially and environmentally responsible investment, member communications, and public reporting.