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Sustainability: The tectonic shift transforming investing

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The past year has seen a marked shift in society's attitudes toward sustainability. This shift is spurring political pressure, a regulatory push and technological advancements to create the foundations of a more sustainable world, leading to a change in investor behaviour and setting in motion a major yet gradual capital reallocation.

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Society’s long transition toward the practice of sustainable investing is likely to drive market adjustments for years and even decades. This tectonic shift has significant implications for the expected returns and relative pricing of assets not just those perceived to be sustainable, but for every asset in the investment universe. The consequences could not just alter existing return drivers or risk premia, but create entirely new sources of premia.

One commonly held view argues that sustainable investing is not going to offer much return opportunity to investors from a basic financial theory perspective. This view holds that today’s prices should fully reflect the predictable component of future flows into sustainable assets, that is, the adoption of sustainable investing is already at a “steady state” reflected in current prices.

We believe the commonly held view is not just wrong, but that the opposite will occur. The coming capital reallocation is not yet in prices: this long transition in sustainable preferences and practices will make some assets more expensive (those with high sustainability) and others cheaper (those with low sustainability). This means that assets with high sustainability will be rewarded through the long transition period, the opposite of what others posit.

All about the flows

There are three channels through which sustainability will change investment: profitability, risk and investor flows. The industry is typically focused on the first two: research has helped quantify the impact of sustainability on profitability and risk in different industries. Yet we believe the third channel is underappreciated – and far more important: the impact of major flows driven by the widespread adoption of sustainable investing during the long transition period.

Our argument that flows will drive a “sustainability wave” is about much more than just the idea that today’s youth and their preferences affect market pricing. Though this contributes to the story, as we discuss below, the sustainability wave and its market impact is about a broader shift in preferences spanning all generations and societies. The sustainability wave is not purely about demographics. But it provides a parallel. Just as the Baby Boomer generation’s impact on the economy and financial markets played out through taste preferences and wealth flows, the sustainability wave will play out over decades, remaking economies and industries as capital is reallocated.

One contributing factor to the wave is, however, demographically induced: an ongoing transfer of wealth to a younger generation with greater awareness of sustainability. Millennials and Gen-Xers are expected to gain a major share of assets. Some might argue that the younger generation’s preference for sustainability may dampen if not reverse as they age. Yet academic literature underscores that the personal experiences of economic fluctuations play an important role in persistently shaping individual preferences, especially at a younger age.

A systematic approach

While the transition period toward a new steady state could last decades, the resulting returns we expect during the transition should impact the strategic asset allocations built today. To meet these challenges, a portfolio construction framework needs to allow for:

- The impact of climate change and other sustainability effects on fundamental macro variables,
- A clear link between the impact of these altered macro variables and the risk and return for all assets,
- A means of allowing for the time-varying nature of the return and risk impact,
- The creation of new sustainability premia that involves identifying factors that exhibit the sustainability premia and discounts within and across various asset classes, and
- A systematic means of building portfolios to reflect the inherent uncertainty applied to all future estimates.

Deriving a set of factors and rewards to sustainability from which to create these new CMAs is not trivial. Our flows-based concept is intuitive and drives sustainability premia. The challenge is quantifying the impact. Our argument is built on the idea that what's priced now doesn't reflect what will be priced in the future. We instead identify exposures that capture sustainability using BlackRock's proprietary sustainability metrics across asset classes. In our framework, whether these metrics have historically explained returns is secondary to whether they capture sustainability. To these identified exposures, we would ascribe a reward or discount by combining estimates of steady-state premia and the time-varying return impacts of the transition period until that steady state is reached. While quantification of this is difficult, there are different parallels from history that are informative. The pace at which markets price in slow-moving effects has precedent.

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