

Tomorrow's Company

Sustainable Capitalism & the transition to a low carbon economy



By David Blood

February 27, 2013

Generation Investment Management LLP
20 Air Street
London
W1B 5AN
U.K.
Main: +44 (0) 207 534 4700
Fax: +44 (0) 207 534 4701
suscap@generationim.com

The Generation Foundation is a distinct, not for profit, undertaking from the group of investment management businesses affiliated with Generation Investment Management. While the Generation Foundation is funded by GIM it is independent from it. Specifically, the Generation Foundation does not carry on any form of investment business and is not authorised to do so. The material is provided for general purposes only. This material is © The Generation Foundation and is licensed under Creative Commons Attribution 2.0 UK. This means that you are free to share the content by copying, distributing and transmitting it, but please attribute it to the Generation Foundation and provide a link to its website. For any reuse or distribution, you must make these licence terms clear to others.

Tomorrow's Company

Sustainable Capitalism & the transition to a low carbon economy

February 27, 2013

I am here today by chance. (Not at this gathering, I mean in finance). Many years ago when I went to university, I started studying to be a teacher. Sadly, half way through my studies, my college closed the education department. Without a concentration, I looked for the closest discipline to education and chose child psychology (By the way, child psychology is great preparation to manage investment bankers and fund managers). As my coursework neared completion, I applied to the Peace Corps and was rejected; and applied to study for my Masters in psychology and was rejected. Panicked that I was heading back home, my father suggested I tried banking. I applied to 70 banks and was rejected by 69. But I received one yes and my career in banking began.

My partner Al Gore likes to say he's a recovering politician, on about stage 9. Yet, I've never considered myself anything other than an investment banker. Call me naïve, but when I started in banking over 30 years ago, I did not believe I would have to check my values at the door. I believed then as I believe now finance can be a force for good. Sadly though, events of recent years make that statement sound silly, capitalism is in crisis and we in finance are dangerously close to losing our license to operate.

To paraphrase Winston Churchill, Capitalism is the worst economic system, except for all the rest. To be clear, capitalism has great strengths. It is more efficient in allocating resources and in matching supply and demand. It is demonstrably effective in wealth creation. It is more congruent with higher levels of freedom and self-governance than any other system. It unlocks a higher fraction of the human potential with incentives that reward hard work, ingenuity, and innovation. These strengths are why it is at the foundation of every successful economy.

However, when it comes to the current global capitalist system, I think an observation by Lao Tzu poignantly captures the issues. His words were, "If you do not change direction, you may end up where you are heading."

If the flaws of modern capitalism (i.e. a rising inequality, short-term profit maximisation, misaligned and outsized remuneration schemes, failing to price externalities, and an overreliance on an inadequate measure of growth (GDP) which does not measure what is important like the health of our communities); if these attributes remain the status quo, we will indeed end up where we are heading- towards a financial system that is at best a grossly untapped asset with unrealized potential to power sustainable progress and development, and at worst a liability wreaking havoc on society.

The stark reality is that the challenges facing the planet today are unprecedented and extraordinary; climate change, water scarcity, poverty, disease, demographic shifts and a global economy in a state of constant dramatic volatility and flux, to name but a few. Moreover, these issues are linked.

Both governments and civil society will need to be a part of the solution to these massive challenges, but ultimately it will be companies and investors that will mobilize the capital needed to overcome them.

It's this perspective that shapes our fundamental belief that we must transition to a new paradigm for finance, a paradigm that we call Sustainable Capitalism. Sustainable Capitalism explicitly integrates ESG (environmental, social, and governance) factors into strategy, the measurement of outputs, and the assessment of both risks and opportunities. Sustainable Capitalism encourages us to generate financial returns in a long-term and responsible manner, and calls for internalizing externalities through appropriate pricing.

Those who advocate Sustainable Capitalism are often challenged to spell out why sustainability adds value. Yet the question that should be asked instead is: "Why doesn't an absence of sustainability not damage companies, investors and society at large?" From BP to Lehman Brothers, there is a long list of examples proving that it does.

The business case for Sustainable Capitalism is robust. There are four benefits to companies and by extension, investors.

- i. ESG metrics allow companies to achieve higher compliance standards and better manage risk since they have a more holistic understanding of the material issues affecting the business. This is also about reputation, brand and license to operate.
- ii. Companies can improve profitability by reducing waste and increasing energy efficiency; and by improving human capital practices to better attract and retain their people and reduce employee turnover expense.
- iii. Developing sustainable products and services can increase a company's profits, enhance its brand and improve its competitive positioning.

- iv. Sustainable businesses realise financial benefits such as lower cost of debt and lower capital constraints.

As I mentioned a few minutes ago, one of the biggest failings of capitalism is we do not price externalities, for example global warming pollution. This is a terrible mistake! The most important economic step we can take today is to put a global price on carbon. But we do not have much time.

In Copenhagen in 2009 the nations of the world agreed to limit global temperature rises to 2 degrees Celsius above pre-industrial levels, a goal which gives the planet and our communities a reasonable chance of avoiding catastrophic damage. We have already raised global temperature by 0.8 degree Celsius and many scientists believe warming oceans will release a further 0.8 degrees worth of gases over the next few decades.

Moreover, recently the consultancy PWC released analysis suggesting that to stay on track for a 2 degrees Celsius increase, the global carbon intensity of economic activity would have to fall by an average of 5% per year through 2050. In the last decade carbon intensity reductions averaged 0.8%, and the world has not seen a 5% fall since the Second World War.

Most alarmingly, the International Energy Association forecast that under current policies in 2035 the global energy mix will look very similar to today. They project more gas and less coal, but fossil fuels will still account for 75% of energy consumption, down from around 80% today. BP's Energy Outlook is not much different, it forecasts fossil fuels will still be at 80% in 2030. I acknowledge these forecasts probably understate the potential of renewable energy sources, but it is clear we are not on the 2° temperature rise path. And, as the IEA acknowledges, we could be on the path to 3.6 degrees Celsius or higher temperatures and almost certain catastrophic climate change.

This is where things get complicated for investors. Businesses and markets famously want certainty above all else from government. The lack of concerted climate policy is being interpreted as a signal from politicians to bet against real and meaningful change to the business as usual scenario.

In some sectors the long term story is even more at odds with action on climate. The top 100 coal producing companies have booked resources equivalent to 74 years of production at current rates. Under any reasonable attempt to minimise climate change most of that coal cannot be combusted without assuming a massive scaling up of expensive and unproven carbon capture and storage technology. Said differently, we cannot burn these booked reserves without surpassing our carbon budget. And yet, mining companies are spending hundreds of millions of dollars expanding mines and adding new reserves to their books.

While investors who hold carbon heavy assets may benefit in some ways in the short term from continued inaction, the growing effects of the climate crisis will inevitably harm them

elsewhere. In short, either investors have stranded carbon assets or impaired real estate, infrastructure, farm land, forestry, etc. assets.

In 2006 the British economist Lord Stern estimated the cost of inaction on climate change at 5% of global GDP versus a price of 2% of global GDP to keep warming within 2 degrees Celsius. In the years since, scientists have come to understand more of the wondrous complexities of our planet, but only been more convinced of the cost of inaction.

In fact, the transition to a low carbon economy will need to be the most significant economic event in history. Bigger than the industrial revolution and faster than the pace of technological change we are currently experiencing. Indeed, every aspect of our daily lives will need to change from how we source and consume our food and water to how we heat and light our homes and buildings to how we commute to work.

Business and investors will need to lead. And the good news is the investment opportunity set is wide including water and energy efficiency, renewable energy, sustainable mobility, bio-based alternatives, recycling, re-use and resource sharing and agricultural and forestry solutions.

I will conclude with 3 points. First, the problems with capitalism I outlined earlier, make it increasingly difficult to address the climate crisis. We all must work to make capitalism more long-term, responsible and sustainable. Or, we will indeed end up where we are heading.

The second is economic. Since the global financial crisis, a common view is we cannot afford to take action on climate change. This is misguided.

Energy assets are very long-term (30 years or more). To make investment decisions without a proper price on carbon means we are not efficiently allocating capital.

Second, as a result of the challenge we face with climate change there are important and attractive economic opportunities right now, particularly with energy efficiency.

Most importantly, the cost of inaction is significant. You only need to recall the images of Super Storm Sandy to understand what I mean.

My last point is about ethics and responsibility. Please reflect on the International Energy Association base case temperature rise of 3.6 degrees Celsius. The fact that the markets and all of us as global citizens seem to accept this is astonishing. Either, we believe that 98% of climate scientists and 100% of Academy of Sciences in the world are wrong; or we have given up because it is too hard; or, we are all expecting to be bailed out. Well, as my friend Jonathan Lash says, Mother Nature does not do bail outs. We all need to be clear, in action is choice and 2020 is not far away. We as citizens, businesses and investors, civil society and governments must take action now to make our planet sustainable for future generations.