Tomorrow's Finance

Sustainable Capitalism and the transition to a low-carbon economy

Tomorrow's Finance lecture, 27 February 2013

by David Blood

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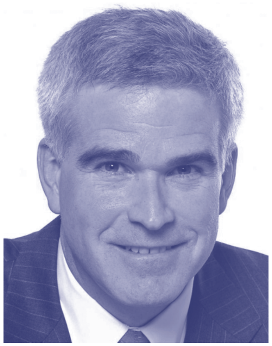

David Blood is co-founder and senior partner of Generation Investment Management. Previously, he spent 18 years at Goldman Sachs including serving as co-CEO and CEO of Goldman Sachs Asset Management from 1999-2003. David received a B.A. from Hamilton College and an M.B.A. from the Harvard Graduate School of Business. He is on the board of Harvest Power, New Forests, SHINE, Social Finance UK, Social Finance US, The Nature Conservancy, Fondation Lombard Odier and Hamilton College; the Advisory Board of Bridges Ventures and the Harvard Business School Visiting Committee.

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 in life 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 unrealised 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, migration, urbanisation 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 mobilise 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 internalising negative 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 does 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.

1. Developing sustainable products and services can increase a company’s profits, enhance its brand and improve its competitive positioning.
2. Companies save money by reducing waste and increasing energy efficiency and by improving human capital practices so that retention rates rise and the costs of training new employees decline.
3. 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 about reputation, brand, and license to operate.
4. 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 today 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 warming 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.

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 (IEA) forecasts 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 forecasts fossil fuels will still be at 80% in 2030. If these forecasts are right then – as the IEA acknowledges – we will 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.

And in some sectors the long-term story is even more at odds with action, or lack thereof, 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. Last year was the hottest year in United States history and the drought in the US Plains has driven up global wheat prices, squeezing margins for food manufacturers. As water levels have fallen in the Mississippi River, the Army Corps of Engineers have become concerned about their ability to keep the river navigable. It is not just the river infrastructure which is at risk of being stranded; it is the supply chain impact for the $7bn in goods that use it as a low-cost route to markets.

Even before Super Storm Sandy hit, Munich Re was acknowledging that extreme weather is increasing in the United States. They warned that this would have cost implications for insurers and investors. This story will only become more dramatic as temperatures continue to rise and storm systems become stronger and more frequent.

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. We must act.

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 or conferences.

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. However, there is no one silver bullet – not wind, or solar, a carbon tax or carbon capture – we need them all.

I will conclude with two points. The first is economic. Since the global financial crisis, a common view is we cannot afford to take action on climate change. This is misguided for three reasons:

First, 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. And lastly, 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. I acknowledge the forecast probably understates the potential of renewable energy sources, but that is not my point. 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, inaction is choice and 2030 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.

Thank you.

About Miton

Miton is a leading multi-asset and equity fund management specialist. The group manages £1.8bn of assets including nine OEICs, three investment trusts and segregated client accounts. Members of the fund management team invest in their own funds and are significant shareholders in the company. Miton has offices in Reading, Liverpool and London.

www.mitongroup.com

About Tomorrow's Company

Tomorrow's Company is the agenda setting 'think and do' tank which looks at the role of business and how to achieve enduring business success. We focus on strong relationships, clear purpose and values as the foundation of effective leadership and governance. In our programmes we challenge business leaders around the world to work in dialogue with others to tackle the toughest issues. We promote systemic solutions, working across boundaries between business, investors, government and society. We believe that business can and must be a 'force for good'. This in turn requires a strengthening of stewardship by shareholders in partnership with boards of companies. We argue that the Age of Sustainability has begun, and that in the future success and value creation will come from recognising the 'triple context' – the links between the economic, social and environmental sub-systems on which we all depend, and the opportunities this brings.

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About Slow Finance

Slow Finance by Gervais Williams focusses on the types of businesses that banks and other financial institutions should finance, the criteria they should adopt and above all the nature of the relationships which can best secure long-term returns – such as exploring in depth financing for food production and other areas vital for economic prosperity and future wellbeing.

To order the book and use the app: **www.slowfinance.com**

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