Long-term investors absolutely cannot afford to function without a Climate lens (and why that may not be enough)

Vikram Raju
Head of Climate Impact Investing

Part 1: We are all climate investors now.

Or should be. Investing is about pricing future cash flows and there's no credible way to do that without factoring in the impact of climate risk on everything from input costs to supply chain resilience. Will monsoon floods in Asia delay electronic shipments to California? Will damage from increasingly frequent storms lead to higher marine insurance premia in the Caribbean? What happens to the cost of water-intensive products like almonds in an increasingly dry Australia? These are questions related not just to extreme weather events but also to long-term structural changes in weather patterns and rising resource scarcity.

Climate risk is but one side of the equation. Serious investors also can't be oblivious to the growth opportunities created by compelling climate innovations and changing consumer preferences. Anyone not paying attention to energy efficiency software or electric cars or meat alternatives has missed out on hockey-stick like growth in what are robust new markets. Unsurprisingly, many traditional large corporates are moving into these sunrise markets. Equally, many of these climate-focused companies are going directly to equity markets – where consumer preferences are also changing – to crystallise investors beliefs about their future cash flows. Tesla today has a larger market capitalisation than Ford, GM and Volkswagen combined.

> "We've come a long way from the question – legitimate at one time - whether it is possible to generate returns while creating climate impact."

The history of climate investing 1.0 is largely well-known at this point: the high profile cleantech failures of that era, the unwieldy technology and high cost of renewable energy generated poor returns in the 90s and 00s. The perception that climate investing leads to low returns has lingered until quite recently - in a cognitive dissonant way - even as we've witnessed the rise of climate-positive companies.

The question today, hopefully, is not whether it is at all possible to generate strong long-term returns while creating climate impact. The question is rather whether it is even possible to generate those returns without taking into account climate impact.

So climate is becoming mainstream. At one point, the story could have ended there and we would have declared victory and gone home. Except...

Part 2: Some positive climate impact isn't good enough.

The scale of the problem is known (52 GT of CO2 per annum) as is the length of time available to us to solve the problem (2050). So while climate lens investing is a must for any long-term investor looking to generate financial gains for their stakeholders, for those institutions that have committed to a climate agenda, there must be a specific and ambitious ask of any climate impact strategy they back.

COP26 in Glasgow is over the horizon as this goes to press and, we hope, there will be a brace of serious climate commitments made by major asset owners. Operationalising those commitments is the hard part. Getting to net zero is a complex journey for most asset owners investing across multiple asset classes. But making an investment in an explicitly climate strategy is the one part of the puzzle that should be more straightforward: Not only should it be carbon negative, it should be carbon negative by a magnitude that moves the needle. This is the only way stakeholders can connect the dots between the problem facing the planet they live in and the impact their capital is having on that problem. Impact reporting – which has come very far in a commendably short period – isn't a good thing in itself.

If they are to meet their climate commitments, investors must strive for a substantial goal that is trackable and reportable. Put simply: what is the most CO2 impact needed for every Euro invested in a climate strategy that is also solving for commercial returns.

There will, of course, be questions of data, methodology and frameworks which need resolving but the resolution doesn't come until the problem is posed. The urgency of the problem forces the question of intentionality. We have to fix this electric plane as we're flying it.

Private markets investors have the benefit of taking a long-term view and create value through diversified portfolios that can combine a range of climate positive, carbon negative investments ranging from food and fertilizer to building systems and energy software. We need to deliver that value while also catalysing climate change at a Gigaton scale.

While this is likely a stretch goal for most climate investors, the scale of the climate crisis justifies this need for this kind of ambitious climate impact underwriting. Delivering modest climate impact alongside strong returns is the equivalent of applying iceberg-proof paint to the hull of the Titanic. One may feel good about it but it won't change the outcome.

Private markets investors also have a very elegant mechanism in the form of carried interest/performance fees that are paid above a financial threshold. Linking this carried interest to the achievement of a specific, significant, climate goal – over and above the financial performance hurdle – will help concentrate the minds of investment teams at the underwriting phase. Assume for a moment that all the questions related to measurement, certification, attribution can be resolved over the long life of these funds with the LP Advisory Committees ("LPAC") having a final say as to whether the threshold has been achieved. There's a further interesting question about where the forfeited carried interest goes in case the fund falls short of its climate goals. Here too, the LPAC can determine whether that capital simply remains unpaid or whether it gets directed to some non-commercial (potentially high risk or low return) venture that can make up for the CO2 target shortfall.

Climate investing has come a long way in a short time but it is now critical to get very specific and ambitious about the expected impact in our investments. Asset owners and investment managers must be willing to think creatively about traditional fund mechanisms in order to genuinely attempt to solve this problem for our stakeholders.

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