Aligning strategic asset allocation to achieve positive sustainability impacts

Topic of the month September 2019

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Since the launch of the Principle for Responsible Investment (PRI) in 2006, asset owners and asset managers have increasingly focused on incorporating environmental, social and governance (ESG) issues into investment analysis and decision-making processes. However, activity is predominantly focused at the asset class level. Investors are now turning to the question of what it means to integrate ESG considerations into strategic asset allocation.

Analysing the impact of sustainability megatrends

The guiding rationale for integrating ESG issues into investment processes is that doing so will drive improved long term investment returns by better managing risks, and increasingly also by better identifying investment opportunities associated with sustainability factors and trends. These sustainability trends – such as climate change or rising inequality – and their associated economic impacts can also influence long-term expected returns for different asset classes.

For example, a recent report published in the National Bureau of Economic Research[1] by researchers from institutions including the IMF and the University of Cambridge analysed the long term macro-economic effects of climate change on GDP. In a scenario where global temperatures rise by 4 °C by 2100, the study predicts a 10.5% fall in GDP in the USA, 13% in Canada and 12% in Switzerland. These impacts could materially influence asset class return assumptions.

The inclusion of climate-related scenario analysis in the Taskforce on Climate-related Financial Disclosure recommendations has prompted an increasing number of investors to review the transition and physical risks associated with climate change. Last year we published our first report on the impact of low carbon transition scenarios on equity valuations[2]. This is contributing to a better understanding of the investment implications of climate-related transition risks.

Aligning capital to deliver on the UN Sustainable Development Goals (SDGs)

The UN Sustainable Development Goals and Paris Climate Agreement outline a roadmap to address these global sustainability trends and challenges including poverty, inequality, climate and environmental degradation. Failure to achieve these goals can present significant sources of systemic risk, in particular for large universal asset owners. Conversely, the SDGs represent a useful lens for identifying investment opportunities and a potential source of global GDP growth.

There is no doubt that achieving the goals requires significant capital. The UN Commission on Trade and Development (UNCTAD) has estimated that globally, an annual investment of $5 to $7 trillion is required to meet the SDGs

over the implementation period 2015 to 2030. Based on current investment levels, we face an annual investment gap of between $1.9 and $3.1 trillion.

Institutional investors are increasingly seeking to measure or indeed target a specific allocation to financing the low-carbon transition and other SDGs whether via listed equity, credit, infrastructure or other asset classes.

The efficient risk/ return and impact frontier?

Traditionally Strategic Asset Allocation is underpinned by assumptions about returns, risk and correlation for a range of asset classes. An optimal mix of assets is then sought on the 'efficient frontier' to minimise risk and maximise expected levels of return to meet investment objectives. Taking into account the sustainability impact of each asset class and the implementation of each asset class can result in more meaningful allocation of capital to SDG-aligned investments. This may lead investors to consider different types of investments which may not commonly have their own allocation or to choose different investments within asset classes.

Green bonds are an excellent example of an asset class where the use of proceeds are directly focused on climate and environmental related outcomes. If sustainability impact is to be used alongside risk and return, there needs to be a clear framework for measuring that impact. We recently launched our Green Impact Investment Guidelines[3] which set out clear definitions of eligible projects and activities for our impact strategies.

As the debate deepens - and we note the PRI has recently published a discussion paper on this topic - we may see a greater focus on aligning strategic asset allocation to achieve tangible sustainability impacts, thereby unlocking more capital to finance the SDGs while delivering on risk and return objectives.

1 https://www.nber.org/papers/w26167
2 https://www.assetmanagement.hsbc.co.uk/-/media/files/attachments/uk/common/exploring-scenario-analysis-for-equity-valuations.pdf
3 https://www.global.assetmanagement.hsbc.com/about-us/responsible-investing

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