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Isio Private Capital: Introduction to Sustainable Investing.

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Executive Summary

As a general observation and based on our experience, we have seen that broad ESG-focused strategies have had less traction with private investors and their family offices compared to institutional investors. In part we attribute this to the lack of a regulatory driver as well as more nuanced governance structures. However, we believe the next generation of private investors will increasingly value **sustainable impact investments**, enabling them to assert their beliefs ahead of financial returns. In this article, we touch on the potential economic benefits of considering **sustainability themes**, both from a return driver and risk management perspective, as well as highlight the wide range of opportunities available to investors within this space.

As environmental and social concerns rise in prominence, we are increasingly aware that **our investments do not live in isolation of real-world impacts**. Our research suggests sustainability risks have the potential to impact portfolios, multiplying beyond the climate emergency. A **cohesive approach to sustainability** is key to implementing a robust portfolio risk management approach which can identify and manage environmental and social risks, which in turn has the potential to generate better portfolio risk-adjusted returns for investors. We believe that sustainability factors will have a material financial impact on investment portfolios in the long-term.

We therefore see investors increasingly focus on sustainability themes to **create positive change and**

impact on issues that they care about, as well as to **improve financial characteristics**, in particular downside risk management.

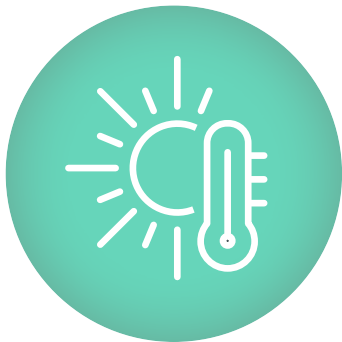
There are a wide range of sustainability themes that investors are increasingly focused on within risk return frameworks. Within this article, we focus on three particular sustainability themes; **Climate change, Nature exploitations** and **Rising global inequalities**. At Isio, we do not view these themes in isolation but **inextricably linked**. In our experience, we feel there is a tendency for investors to have a '**climate tunnel vision**' focusing largely on emissions reduction. However, we are now seeing investors consider a wider range of sustainability factors as part of a more holistic risk management approach.

Positively, investors have a **range of implementation options to consider**, across multiple asset classes and sustainability themes. The diversity and complexity of products available is substantial and we can support investors throughout this process.

Whilst this article provides an introduction to the issues of climate change, nature exploitations and rising global inequalities which impact investment decisions, we consider it critical to understand these interlinked issues and believe that a true sustainable strategy should consider multiple sustainability themes. We will shortly publish a follow-up article which outlines how a sustainable strategy can be implemented in practice.



Key sustainability themes



Climate change

- We have seen climate change rise to the top of everyone's agendas, from investors to governments alike. Scientific researchers have issued warnings of the planet **warming to un sustainable levels**. We believe this will result in **significant environmental and financial impacts**. For example, our proprietary climate model demonstrates that climate risk could cost over 50% of GDP this century and hence is a material financial risk for investors to consider.
- Climate risks have become an important factor within investment decisions and analysis given the potential impacts on investment markets. The key risks to consider are:
 - **Physical** - those which arise from acute and extreme weather events and chronic shifts in weather patterns. These physical risks are hard to price into investment markets, potentially exposing stock markets to price shocks, with knock on impacts that may also impact wider asset classes.
 - **Transitional** – driven by the transition to a low carbon economy. Transition costs for polluters may be significant over the near to mid-term (over the next c.30years), which may impact return potential across asset classes and certain sectors.
- The climate market is growing exponentially, with **climate finance** flows reaching c.\$1.3 trillion in 2022, nearly double since 2020. There however remains a finance gap should countries seek to keep the hope of meeting the Paris Agreement alive, to keep global temperature rise to well below 2 degrees.
- The low carbon transition may offer various **climate-related opportunities** for investors, and it is important to identify those assets that are best placed to benefit from decarbonisation efforts. For example, low carbon transport and renewable infrastructure will likely benefit from increased government support and incentives, to support carbon emissions targets. Fund managers identifying these opportunities can seek to generate superior returns and manage climate transition risk.
- **Carbon markets** is also a growing area, with the aim to place a price on carbon to encourage the highest emitters to reduce their emissions. We believe investors could further explore opportunities within carbon credits and carbon price hedging as return diversifiers as well as for portfolio risk management.



Nature exploitations

- A nature positive future consists of **living harmoniously with nature** in a way that enriches biodiversity, whilst alleviating global risks such as climate change.
- **Certain ecosystems are essential to life on our planet**. With half of global GDP – around \$44 trillion – dependent on nature and its services, it is important to account for **nature risk** within portfolios and overall risk management frameworks. As with climate risk, there is a physical cost of a nature breakdown; for example, pollination species are vital for crop production and provide c.\$200 billion, in pollination benefits for the agriculture sector.

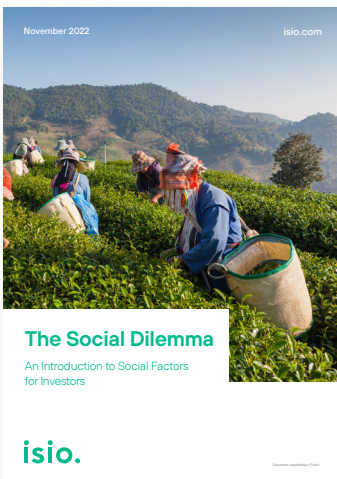


- We believe investee company supply chains and revenues are becoming increasingly **sensitive to nature degradation**. Those companies that are able to adapt, as well as support nature restoration, are likely to fair better in the longer term.
- In our experience, investors are increasingly seeking nature-based investment opportunities, especially given its ability to create win-wins for delivering nature and climate objectives within portfolios. **Nature-based solutions** focus on actions designed to **protect, manage, and restore ecosystems** that provide environmental and financial benefits. These products may generate carbon credits, an area in which we see increasing investor interest seeking diversified returns.
- The private sector can play an important role at bridging the finance gap to achieve **global nature targets**. We believe there are nature opportunities across asset classes, from real asset investments in forests or agriculture, to green corporate or sovereign bond issues, sustainability performance linked loans, or equity opportunities in listed or private markets.



Rising global inequalities

- Climate and environmental issues have often dominated investor agendas leading to a tendency for a **'climate tunnel vision'**. We have therefore seen less progress in investors seeking to **tackle various social concerns**, covering such issues as human rights violations, modern slavery, and access to clean water and healthcare.
- **Recent geo-political events** such as the Ukraine-Russia conflict and the cost-of-living crisis have contributed to short term market volatility. This emphasises the importance of considering social factors as part of a holistic approach to downside risk management. Identifying and managing such risks will typically be captured as part of a broader sustainable or impact strategy rather than as a dedicated social product.
- Social factors can be difficult to define. However, the UN's **Sustainable Development Goals** ('SDGs') provide a starting point for identifying social focus areas with improving inequality being a key driver for many of the goals, including access to clean water, education and healthcare. According to a recent United Nations Trade & Development ('UNCTAD') report, there is a finance gap of c.\$4 trillion in delivering the SDGs, suggesting that private markets could play a significant role.
- We know that a **changing climate will exacerbate global inequalities** and that the transition to a lower carbon economy requires a social focus. The **just transition** aims to ensure that the transition to a greener economy is **fair and inclusive**, for example the re-skilling of high carbon workers to low carbon jobs.
- There are an increasing number of products with a focus on **driving action on social issues**, from real asset investments in social housing, to social corporate bond issues, or equity opportunities in listed or private markets.





Environmental and social factors are interlinked, both on a financial and humanitarian scale. The sustainable investing product landscape is diverse which means investors can often find an investment product which meets their priorities and objectives. These investment decisions should be **grounded in financial drivers** as well as to drive positive impact across sustainability themes. **At Isio, we can support our clients on their sustainability journey**, whether they wish to target multiple sustainability themes or have a specific area of focus. There is a myriad of institutional providers in these areas and we have firsthand experience of researching the participants, forming our view on which approaches best meet an investor's objectives. Beyond measuring the level of sustainability integration within investors' portfolios, we can advise and design **bespoke investment strategies** that aim to meet all sustainability priorities in an efficient and diverse manner.

Our Sustainable Investment team have a wide range of experience advising significant institutions across asset classes. We apply this shared learning to the objectives of our Private Capital clients, where our insight can help to identify which managers meaningfully **meet their sustainability goals as well as their financial return and risk targets**. In a financial world awash with jargon, mixed metrics, data points, truisms and technical content, understanding the wider context, positioning and capabilities of providers is a real challenge. **Aligning investor objectives** is therefore a significant research exercise that requires a trusted partner. Independent and entirely client aligned, Isio looks forward to being your guide on the sustainable impact journey.

We will shortly publish a further article which will outline how we can best support clients to implement a sustainable strategy in practice and the investment case for doing so.

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