The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

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WHAT IS 'THRESHOLD INVESTING' AND WHY SHOULD YOU KNOW?

"Human needs must be satisfied while respecting the outer limits of the planet's physical integrity."

Barbara Ward, UNEP

"We have learned to use technology to augment human carrying capacity temporarily….leading to inevitable ecological overshoot."

William Catton, "Overshoot"

"Humanity is an integral part of an interconnected web of life in which there is no real separation between 'us' and 'it'. The scale of the human economy matters in relation to the biosphere in which it is embedded."

John Fullerton, "Regenerative Capitalism"

"We are now in a place of overshoot and collapse….yet most of the mainstream economic discipline still fails to recognize this reality."

Joe Brewer, "The Cultural Evolution of Economics"

"Value is to be interpreted by reference to thresholds established by evidence about carrying capacity and limits of resources….the purpose of corporations should be understood in terms of what society and the environment can tolerate and survive."

EY, "Value Creation"

"Would you invest in companies that habitually operate beyond their financial budgets? Prudence suggests not. What about companies operating outside an ecological budget? Prudence speaks with the same tongue, but most investors are not listening."

Baue, McElroy, Krosinsky, "Investing 2.0"

The Common Message in the Quotes

Despite their time-span of 45 years, the six quotes above convey the same message. We live on a planet with finite social and ecological carrying capacities, and we have been overshooting those capacities for quite some time now. The question facing asset owner organizations today is how to respond to these increasingly clear realities. The answer is also increasingly clear. At a micro level 'sustainable investing' means investing in organizations that operate within explicit social and ecological thresholds, and at a macro level 'sustainable finance' means steering global economic activity to remain within social and ecological thresholds at the planetary level. The clearer these realities become, the clearer the fiduciary duty becomes to deal with them at both micro and macro levels.

Of course, saying is one thing, doing another. What are the tangible implications of fulfilling these fiduciary duties? Where are we in our ability to actually establish social and ecological thresholds at micro and macro levels? The short answer is 'not as far along as we should be'. Providing a longer answer is the goal of this *Letter*.

The Great, Green Transformation

Compelling narratives that transform passive hand-wringing into positive action are an important part of the longer answer. Author Jeremy Rifkin has been very good at this, as evidenced once again by his article "**The Great, Green Transformation**" in the Globe&Mail, Canada's national newspaper. Here is a summary of what he wrote:

- Scientists tell us we are facing an existential global climate emergency.
- Millennials and GenZers are mobilizing for revolutionary action in 150 countries in "the first planetary revolt of the human race in the 200,000-year history of our species on Earth".
- The focal point of this revolution is a "Green New Deal (GND) to save life on earth".
- Growing momentum for the GND has both political and business dimensions.
- Key economic sectors (IT, communications, power generation, transportation, logistics, real estate) are decoupling from fossil fuels to cheaper energy sources and accompanying green business practices and processes.
- New studies suggest a potential $100T 'carbon bubble' in stranded fossil fuel assets, possibly within a decade.
- Like in the 1st and 2nd Industrial Revolution, this 3rd Revolution is driven by the integration of three elements: new communication media (the internet of things and big data), new power sources (renewable energy), and new transportation mechanisms (digitized autonomous vehicles).
- Globalization will become 'glocalization' as individuals, businesses, and communities connect with each other around the world.
- The dark side of all this will require vigilant regulatory oversight at international, national, and local levels.
- The financial sector in general, and asset owners in particular, have major roles to play in implementing the GND transformation.
- Transition to the 1st Industrial Revolution took 30yrs (1860-1890), and to the 2nd one 25yrs (1908-1933). Many aspects are in place to complete the 3rd one in 20yrs (by 2040). We need to be hopeful that will be in time.

Where does 'threshold investing' fit in all this?

Towards Threshold Investing

A recent practical attempt to describe 'threshold investing' comes courtesy of the *New York State Common Decarbonization Panel*, and its Report: "Decarbonization Panel Beliefs and Recommendations". Readers will recall the Report was the subject of our May ***Letter***. On the topic of 'threshold investing', the Panel suggest testing investments for their "consistency with a +2C degree future or lower". Such investments may directly or indirectly work to help create that future or have a neutral effect on its development. To help visualize this, the Panel offers a counterfactual: "Unsustainable assets assume expected values that are inconsistent with the physical impacts and transition pathways of whichever warming scenario is assumed. Sustainable assets have integrity against science-based assumptions. Unsustainable assets do not". To that end, they propose a 'minimum standards test'.

Importantly, a Report appendix provides guidance and examples of what such a minimum standards test could cover:

- The standards could relate to achievements, behaviours, or positions, could be quantitative, qualitative, or both, and should be timeframe-specific.
- There should be clear actions tied to the standards that are not met.
- The standards could relate to individual companies, sectors, asset classes, and regions.
- Areas where standards could be set include GHG emissions, water management, lobbying activities, corporate governance practices, hiring policies and compensation structures.
- In addressing climate-related transition risks, a logical sector to start setting minimum standards would be fossil fuel producers.
- In addressing climate-related physical risks, a logical place to start setting minimum standards would be for organizations in the real estate, infrastructure, and property insurance sectors.

While this guidance is useful, it cannot be the end of the 'minimum standards test' story. In fact, it is only the beginning.

So What Is Next?

A specific answer to the 'what is next?' question is the *Sustainable Finance Blueprint* project, which is the brainchild of Bill Baue and Ralph Thurm and their global 'common-good' organization. The name of the organization is very short: *r3.0*. The first draft of the *Sustainable Finance Blueprint* is currently out for comment from the Working Group. The second draft is to follow, and then the *Final Blueprint* release at the *r3.0* Annual Conference in mid-2020.

So what does Draft I have to say about 'threshold investing'? It provides a great deal of background and context, some of which is summarized in this *Letter*. It references two recent UN reports that bring the concept closer to reality. A 2015 UNEP report titled 'Raising the Bar: Advancing Environmental Disclosure in Sustainable Reporting" made four key recommendations:

- Multilateral organizations should collaborate to create a global governance body of scientists, academics, business practitioners, NGOs, and other stakeholders to provide guidance on methodologies for establishing ecological and social thresholds, as well as guidance on approaches to allocations at the business level.
- Rating agencies should develop frameworks and mechanisms to apply context-based assessments of corporate sustainability performance based on publicly available data routinely disclosed in sustainability reports.
- Reporting standards/guidance bodies such as GRI, IIRC, SASB, CDP should integrate Sustainability Context more explicitly into their frameworks, for example by applying the concept of carrying capacities to multiple capital-based frameworks.
- All companies should apply a context-based approach to sustainability reporting, allocating their 'fair share' impacts on common capital resources within the thresholds of their carrying capacities.

A follow-on 2019 UNRISD report addressed the question of sustainable development performance indicators. It proposes the Sustainability Quotient as the ratio of the actual impact of an entity on the carrying capacities of the multiple capitals defined in the *Integrated Reporting Framework* versus objective science-based normative indicators. The nature of these capitals can be financial, manufactured, social, or natural (e.g., air, water).

Operationalizing such a measurement framework will require hard work. For example, a survey of 40,000 corporate responsibility reports over a multi-year period found that only 5% of the reports mentioned ecological limits, and in a tiny 0.3% were those limits integrated into corporate strategy. Does that mean the remaining 99.7% are "unsustainable assets" in New York State Common Panel parlance? No, but it does indicate the length of the road to be travelled to move to an operational threshold investing framework.

A Path to Threshold Investing

What does a plausible path to threshold investing look like? The *Sustainable Finance Blueprint Exposure Draft I* suggests starting with the Montreal Pledge taken by asset owners to calculate the carbon footprints of their asset holdings. This provides the numerator of the Sustainability Quotient (i.e., actual impact). The next step is to calculate the denominator, their fair shares of the planetary carbon budget. Over the past few years, more than 650 companies have taken this next step by calculating their Science Based Targets (SBTs).

Asset owners can follow a similar path. For example, they could adopt an economic allocation (i.e., percent of GDP) approach applied across all sectors to calculate a portfolio carbon budget. This facilitates assessments if the portfolio's actual carbon footprint exceeds its calculated carbon budget, and helps identify which investee companies are causing this overshoot. The *Blueprint* calls for extending this carrying capacity approach across multiple capitals, including natural, social, and financial. Readers will recall that the *Integrated Reporting Framework* applies this multiple-capital approach at the organization level. Earlier *Letters* this year have shown how the Framework can be adapted to asset owner contexts.

More to Come

The journey to threshold investing is not an easy one. For example, this *Letter* only reports on the key elements in *Exposure Draft I* of the *Sustainable Finance Blueprint*. *Drafts II* and *Final* are still to be written, based in part on feedback received by the authors from *Draft I*. We will return to the threshold investing topic later in 2020. Meanwhile, there is much asset owners can do to move their investment models towards a threshold investing framework.[i]

Keith Ambachtsheer

<u>*Endnotes:*</u>

i. *For example, the recommendations of the Taskforce on Climate-Related Financial Disclosures (TCFD), which in addition to governance, strategy, and risk management, focused on metrics and targets. Thus they represent an important guidepost on the journey to threshold investing. The recent appointment of Mark Carney as the UN's Special Envoy on Climate Action, to commence when he steps down as Bank of England Governor next year, is a welcome new initiative in the same direction.*

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