The ES&G Bandwagon Must Embrace the Adaptation Side of Climate Action

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This commentary is part of a series on emerging issues from Adaptation Leader

With the explosive growth of environmental, social, and governance (ES&G) investing in recent years, it appears that we may be at or approaching an inflection point. As ES&G investing becomes ever more prominent, it may be timely to ask whether, as currently practiced, it considers all issues of material importance to investors. In this commentary, Adaptation Leader suggests that current ES&G research, analysis, and investing practices pay insufficient attention to one of most important issues of our time: how people, societies, and companies will adapt to a changing climate, and what that portends for stock and corporate bond investments.

ES&G: A Mature Concept Coming into its Own

Much has recently been written about ES&G, or Environmental, Social, and Governance. This term, and the industry in which it is practiced (financial services) has recently generated a lot of buzz, attracted a number of new participants, and, apparently, produced a growing number of "experts." During the past several years, ES&G has attracted impressive levels of media attention and commentary, and it has engendered a large number and wide range of meetings, conferences, and webinars.

More fundamentally, ES&G research, analysis, and investing comprises a large and rapidly growing sector of our capital markets. Reliable estimates indicate that at least one in five dollars in U.S. equity markets is invested according to one or more ES&G criteria, with an even higher percentage in European markets. Despite the recent crescendo of media attention, ES&G and its principles have been with us for many years, so we can be confident that ES&G is not a passing fad. Given that fact and all the favorable press, one might be forgiven for assuming that the growth of ES&G investing might be just what is needed to induce a fundamental shift in business behavior to a more sustainable posture. But the question arises: Is the prevailing ES&G paradigm sufficient to get us there? There is reason for skepticism.

One of the major factors driving the emergence of ES&G investing from niche practice to mainstream method over the past 15 years or so is climate change. Indeed, it has long been recognized that a changing climate is one of the relatively few environmental issues[1] that can attract and sustain boardroom-level attention. And to be fair, the importance of climate change as an issue affecting future corporate success has not been lost on investors. Initiatives such as the highly successful Principles for Responsible Investment (PRI) and Carbon Disclosure Project (now CDP) demonstrate that investors are keenly interested in how corporations and their senior management are positioned relative to potential new limits on greenhouse gas (GHG) emissions, rising seas, and other impacts of a changing climate, and have been for some time. Nevertheless, it is fair to ask: do current ES&G analysis and investing

[1] Recognizing that climate change is a complex issue that has many non-environmental implications.

practices adequately address (and encourage) sufficiently robust climate action, including, critically, adapting to the physical risks of a rapidly changing climate?

Let's Return to First Principles

Developing a valid answer to the questions I have posed requires that we have clarity around the ES&G concept. Some of the reporting and commentary around ES&G has suggested that ES&G is synonymous with sustainability or essentially so. This is not the case. It is important to understand that ES&G is and has always been about *investing*. The concept arose over a period of many years from the Socially Responsible Investing (SRI) movement. It represents an evolution of early SRI approaches and methods to reflect the need to improve investment returns and incorporate advances in information quality and understanding of more of the real determinants of financial value.

When you boil it all down, investors care about three things: 1) profits (earnings); 2) growth (increases in sales and earnings over time); and 3) appropriate management of risk. Accordingly, viewed from the perspective of the investor, consideration of ES&G factors must retain (or return to) a focus on those that will affect future opportunities, risks, and competitive advantage. And at a fundamental level, we must remember that investing is about the future. Any time or effort spent examining data on past performance or current capabilities has relevance only insofar as it informs our judgment about the likely future prospects of a company and its investable securities.

ES&G analysis and investing has been growing by leaps and bounds and has become a key driver in inducing the uptake of more sustainable business practices in corporations around the world. Because of their (collectively) large and growing influence, ES&G investors are in a position to drive difficult though necessary improvements in capital deployment and general corporate behavior. To maximize their positive impact, however, ES&G practitioners in all roles must emphasize the need to not only pivot to a carbon-free economy, but also to confront the profound challenges posed by a rapidly changing natural environment. The business community has a large and essential role to play in blunting the severe human, social development, economic, and environmental impacts of extreme weather events, rising sea levels, water shortages, and other effects of a rapidly warming climate.

ES&G investors have produced real momentum and substantial changes in boardroom attitudes and behaviors with regard to important environmental, social, and governance issues in recent years. As noted above, among other concerns, ES&G participants (data providers, analysts, asset managers, and asset owners) have identified and focused on climate change as a significant business/financial issue for more than 15 years. As a direct consequence, we have seen marked improvements in the extent and quality of corporate disclosure of GHG emissions, as well as in the sophistication of management thinking about climate change as a business issue over time. Nevertheless, such disclosures on the whole are still mainly focused on internal emissions reduction efforts, value chain contributions to corporate emissions, and risks to physical locations and continuity of operations. Given this emphasis, will the current ES&G/corporate disclosure framing get us to where we need to be?

The Elephant in the Room: A Rapidly Changing Climate and the Urgent Need for Climate Adaptation

To their credit, the sponsors of several prominent initiatives to promote climate-change related disclosure (e.g., CDP) expressly request information on organizational risks and plans to address them. Accordingly, there is at least some expectation that such disclosures would describe alternatives to business-as-usual conditions and how the reporting entity might respond to them. Perusing a typical annual report or 10(k)[2] will show, however, that even today most corporate planning and forward-looking disclosures reflect the assumption of stable business conditions.

This state of corporate reporting and disclosure poses a problem for investors. Science and recent events tell us that environmental, societal, and economic conditions will look very different in 20 years than they have in historical memory. Among the increasingly likely effects predicted by climate scientists and analysts are the following:

- "Managed retreat," that is, abandonment of major portions of the coastline and other low-lying areas in the U.S. and countries around the globe
- Potentially severe impacts on water availability, agricultural production, human health, productivity, and other fundamental support systems and processes underlying viable societies
- Vast numbers of climate refugees, including in advanced economies, and
- Failed nation states.

In the face of these threats, it is clear that greenhouse gas (GHG) mitigation is necessary (to minimize future climate changes), but not sufficient. Now, and increasingly as these effects compound, adaptation to climate impacts must receive at least commensurate attention, promotion, support, and funding to that dedicated to climate change mitigation efforts.[3] Profound changes in climate and severe weather are now locked in for the next several centuries and will comprise "the new normal." Given this increasingly clear reality, mitigation is necessary to keep us from moving too far out into uncharted and very dangerous territory. Equally important though, is how well we will adapt to the inevitable changes.

The Practice of ES&G Must Adapt

If one accepts that climate change adaptation is vital, the next questions are how to make it happen and where to start. Fortunately, some productive steps have been taken, such as the guidance issued by the Task Force on Climate-Related Financial Disclosure (TCFD) regarding scenario planning. Attention to scenario planning as recommended by the TCFD can facilitate greater focus on the adaptation and resilience challenges faced by organizations and, in turn, inclusion as ES&G factors. Careful planning and investment decisions that take account of climate impacts and include infrastructure that will better withstand these impacts needs to become standard business practice. Facility siting decisions should

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[2] Entities issuing securities (stocks or bonds) in the U.S. that may be purchased by the public must provide regular disclosure of important operating and financial information at defined intervals. These requirements include the issuance of an annual report and accompanying audited summary of key financial information (form 10(k)), as well as quarterly financial reports (form 10(q)).

[3] Indeed, this fact has been acknowledged in the 2016 Paris Climate Agreement.

further account for climate vulnerabilities and the adaptation steps that local governments are taking to address them.

Similarly, a rapidly changing climate requires some rethinking of corporate sourcing. Many organizations will be negatively affected when previously reliable supplies of materials, energy, workers, components and sub-assemblies, and other vital inputs are disrupted. Procurement and distribution systems will need to extensively integrate predicted climate impacts and more agile methods as supply chains become increasingly susceptible to climate change impacts. Thus, adaptation of the supply chain to increase resilience represents an important ES&G consideration. Moreover, as the current worldwide COVID-19 pandemic has amply demonstrated, many companies have already over-extended their supply chains and have eliminated redundancies to the point at which they have become insecure and subject to failure, i.e., not resilient enough to withstand additional shocks to the system.

The number and scale of looming climate change impacts will likely appear with an uneven spatial distribution, so it will be essential for larger, multi-site organizations (e.g., multinational corporations) to evaluate and strengthen existing stakeholder relationships and perhaps, form new ones. This too is a form of adaptation worthy of ES&G consideration. These networks and collaborations will be particularly important in the context of the local communities housing company plants, distribution centers, headquarters, major offices, and other facilities. Partnerships with other businesses and governments to encourage collective adaptation actions where they leverage complementary capabilities and are cost-effective will also be essential.

At a more general level, the challenges posed by the need for climate change adaptation provide corporate and other organizations with an opportunity to examine important aspects of their current orientation and operations through strategic planning. Performed thoughtfully, such strategic planning efforts can yield a revised/clarified vision and mission; actions indicated through a business, portfolio, and/or asset review; a realigned organizational structure; and an updated understanding of indicated management steps to address business and financial risks.

Companies that accept and play this role effectively will prosper in the years ahead, while those that do not will experience increasingly limited prospects and eventual failure. To spur this necessary transition and, as always, provide asset owners with reliable positive risk-adjusted returns, professional investors must demand that corporate issuers provide evidence that they are actively managing their own adaptation to the new world that we are creating.