Sustainable investing

Innovation is key to taking SI to the next level

- Electric cars need software engineers and more efficient batteries
- Shift from risk-avoiding ESG investing towards impact investing
- Focus on long-term value creation rather than shareholder value

Dirk Schoenmaker is Professor of Banking and Finance at the Rotterdam School of Management, Erasmus University. We spoke with him about how sustainable investing relies on innovation, the need to decarbonize now, and why value creation for society is more important than value creation for shareholders..

What is driving sustainable investing at the moment?

'Driving' is an appropriate term, because innovation is the key thing that will take sustainable investing to the next level, and determine who are the winners and who are the losers. This can be seen in the electric car industry.

Five years ago, there was more focus on Elon Musk smoking dope than the electric cars he was making. At the same time, Volkswagen was tampering with the readings from its diesel engines to get better emissions results on paper. They were not busy retraining their staff to become electrical engineers, and now they are hugely behind Tesla. You don't only need to change the factory to make electric cars; you need to retrain the workforce from traditional engineers into software engineers.

And you may not be able to retrain some of them, which means you need to hire new staff, when Germany does not have enough electrical engineering students. By not looking at the future in time, they completely missed out.

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Electric cars need electrical engineers

So, there will be winners and losers from this kind of forward thinking?

Yes, because the same scenario is not true of companies like Toyota and Tesla. For them, it's much easier. Two years ago, if you had said that Tesla would get a subsidy to build a factory in Germany, people would have laughed at you. Now this is happening. The fact that Tesla is building a big factory in Germany, using German taxpayers' money, is basically a failure of German industry. If they had seen this coming, they could have had their own subsidies to build electric car factories in Germany.

It all boils down to innovation. The solution to the Covid-19 pandemic is the vaccine. Governments are not producing vaccines; it is innovative companies who are doing that. Governments can help out with smart R&D subsidies, but innovation only happens in the world of entrepreneurs and companies that want to gain market share. When they first started building the Channel Tunnel, they didn't know at the time what the type of train was going through it – but they built it anyway. That takes vision.

None of this can work without rules. Doesn't regulation still have a role to play?

It's important that regulation doesn't stifle regulation, and I know this because I've been in a major bureaucracy. I once worked at the Dutch central bank, and if you work in a government body, you are not at the forefront of innovation and knowing where the market is heading. So, it's nice to have the Sustainable Finance Disclosure Regulation and European Taxonomy for policy purposes and for retail investors, but wholesale and institutional investors at the front end should keep pushing the frontier, going beyond just following the rules.

How has sustainable investing generally developed in recent years?

What I see is a shift from ESG investing, which is basically done from a risk perspective trying to avoid harm, to impact or investing driven by the Sustainable Development Goals, where you want to make a positive impact. That shift is extremely important, because we are not going to get sustainable development by risk avoidance. We need to grasp the opportunities of making a positive impact.

If we move from risk to opportunity, we can do positive transition investments and then it's getting really interesting. But you can't do that by just using an ESG rating or score; you need to do really in-depth research, investigate the companies, the projects and the infrastructure where you want to invest. You need to investigate what's happening on the ground.

Society is moving towards more sustainable development

One of your beliefs is to prioritize 'long-term sustainable value creation'. How does that work?

In the capitalist system, we are used to listed companies being required to create value for their owners. The purpose of shareholder value is to create financial capital using financial capital. You just want to make a profit. Long-term value creation argues that we need to create social, human and natural capital as well. Society is moving towards using sustainable development to reap future profits by integrating this idea that by investing in society, you create economic value in the future. Much of it relies on human capital, particularly in emerging markets, where there is so much untapped potential. It all starts with people, because it is people who are doing the work. We're often dealing with entire communities, and society does not accept negative natural capital investments anymore.

You can still make a profit with sustainable development, but the trick is you have to apply it to the supply chain, across the full value chain. Paying a living wage to your employees means the whole family can pay the hospital bills, has enough food, and has enough money to pay for the family education. By paying a living wage, you also advance the SDGs for education, decent work and economic growth. And then by doing the decent work, you get sustainable cities and can meet the other goals. Business contributes by offering decent work and living wages in their supply chains.

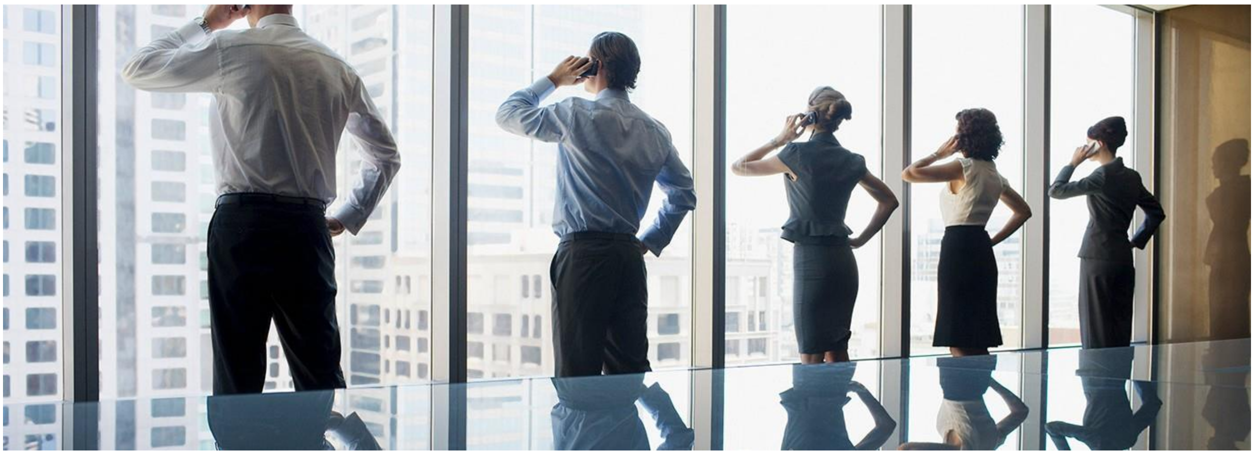
Isn't this an issue for governments rather than companies?

That's an old way of thinking; that's silo thinking – that the government is there to define what is in the common interest, and businesses are there to make a profit. Most of the demand for solar panels and electric cars is coming from public demand, not governments. We now understand that sustainability challenges such as climate change are a challenge for all of us, and not just governments. This is the new insight: that this is a common challenge where everybody has to contribute if we want to achieve it.

It's part of the issue of whether you should lead from the top down or the bottom up. A systems planner will always think that doing things from the top down is the most efficient, because you can make calculations for the whole economy. This kind of planning on paper looks nice, but it has to happen in practice, and that's why bottom up also is necessary. People need to demand these things.

Aren't the SDGs and Paris Agreement top-down initiatives?

Yes they're both UN projects, and they're kind of prodding governments and corporations to meet them using the capitalist system. If we really think about it, production is consumption now. So, yes, governments should play their part. Business should do the parts concerning responsible production, living wages, gender equality, taking care of the environment, and acting as responsible citizens, and then we can meet the SDGs.



Gender equality is a major investment theme

Take the example of fast fashion. We all know that cotton is a major user of water and has an impact on climate change. By demanding fast fashion products, you are part of the water consumption issue. If you use palm oil, then you are contributing to deforestation. Clothing and palm oil both come from industries where a living wage isn't being paid. So, I think everyone needs to engage, not as politicians or business people, but as consumers.

What are the hurdles? Aren't there capacity limits to electric cars and renewable energy?

Electric cars are a good example, as the will to make them is certainly there, but currently there isn't enough cadmium and lithium in the world to make the batteries that could replace all petrol-driven cars. And many cars don't have the range needed for long-distance trips. However, advances in battery technology are moving very fast. The electrical capacity of batteries is limited because they produce heat. Spintronics can improve capacity through spinning electrons that creates magnetism. You just change the way these batteries are structured to get far more capacity without generating too much heat. This kind of innovation will make batteries more efficient – there are people are out there at technical universities and in car factories working to solve it. Again, this goes back to innovation.

It's a similar story with renewable energy. It currently doesn't have the capacity to handle times when the wind isn't blowing, or the sun isn't shining. It doesn't have enough slack yet to handle a shock. If we are to move society to renewable thinking, we must become more resilient to the shocks. A bank has enough capital to absorb a shock, and manufacturing has enough inventory to absorb a shock, but renewable energy doesn't. It's just a matter of scale. Efficiency thinking for managers is opposite to sustainable thinking, where you make shock-proof systems that allow for some slack. If things happen, like when the sun isn't shining as much in the winter, you can still continue. All renewable infrastructure needs is excess capacity for potential shocks.

What about decarbonization? Are the net zero targets a good thing to pursue?

The real problem is that all these decarbonization targets are far into the future, and we need to take action today, not tomorrow. The year 2060 is four decades away, so these targets are pie in the sky. China is still planning to build coal-fired power stations. We know where we need to go, but we need to start today. We have to completely decarbonize the whole of industry and society, which is going to take 20-30 years, so this is only credible if we start today. It's fine to have targets, but if you don't start today, then it's not credible. Starting today means shifting capital expenditure from fossil fuels to renewables; that's where you need to translate it into concrete action.

Renewable energy needs scale to meet slack times

If targets are an issue, will regulation help to move things along here?

The new Sustainable Finance Disclosure Regulation will be useful for sustainable investing, because currently the good guys disclose their sustainability credentials because they get the benefit of it, and the bad guys don't say anything. Now this will need to be done across the board and everyone will know who are the good guys and who are the bad guys.

The EU Taxonomy defining sustainable investment is a plus and a minus. The plus is that retail investors who cannot do the work themselves now get properly labeled products, so they know what they're buying. It will say whether a fund includes tobacco, thermal coal and other things. But I hope that people still do their own work and don't think that the Taxonomy will do it all for them, because otherwise we stifle innovation.

What else could be useful in progressing sustainable investment?

Changing mindsets is necessary to start thinking on a grander scale. You should not think either as an ecologist or an economist, because the solutions are not there within a single domain. If you follow the ecologists, we would stop doing everything, because almost everything that humans do is wrong. Economists think we can buy the whole world, including all the lithium in Congo, and use it today. But of course, we can't. The single solutions are not there, so we need integrative thinking and the mindset to do so. That's very difficult for people if you've been trained as an economist and you think your field is the main discipline. The trick is to get this crossover between sound economics and innovation. And you also need sound government for setting the social and environmental goals for this integrative thinking.

What I discuss with my students is that you don't have to become a specialist, but you do need to understand the basics of climate change, the basics of biodiversity, and the role you personally play in it. That's the basics, and it's not specialist. Having this kind of mindset helps you to get the inter-linkages. And then you can find the best solutions once you are in this mode of new thinking.

What should investors do next?

Step one is to move from passive to active investing, because if you invest in the market index, you are investing in yesterday's economy. You're also investing in the brown economy. Step two is don't rely on the ESG ratings or scores, but do your own research in the real economy. For example, solar panels are often wasted at the end of their life and end up being dumped. Everything in the panel is welded together and you cannot reuse them. But if you construct solar panels in a certain way, you can recycle the components. So, when you invest in solar panel producers, select the ones who do it properly with reusable components. If you do this kind of fundamental research, it can be used to protect your portfolio. Learn what the company is doing, and then make suggestions to the company through engagement. A dialogue improves the company and reinforces your initial investment.

Solar panel innovation is taking great strides

Step three is to stop thinking that markets are the answer to everything. The ECB's monetary policy operations buy corporate bonds in the markets, and most of these come from capital-intensive companies, utilities and oil companies. So, without having the intent, the central bank is buying into a bias towards the broader economy. And when I discuss that with them, they say: 'But that's not our doing, it's the markets that are to blame'. This belief that the market is correct hinders our thinking. The market is good for innovation, but not for other things. By and large, we are all conditioned to believe the market is always correct, so by investing in the market, everything will be all right. That's the failure in our thinking.

What about active ownership to get investee companies to do better?

Engagement works well because money talks, and you can stimulate companies to speed up sustainability if you threaten to divest if they don't. But then is an oil company going to select a CEO who sees transformation to a world of renewables as an exciting opportunity? Most of them don't do this, so half of my students say they wouldn't invest in these companies, as they don't see any inspiration coming from the top.

You should therefore be vocal in your engagement and demand to see credible plans for transition. We all know that this cannot happen overnight, and doing without oil is currently not credible. If you buy an electric car, there are still cars out there using petrol. So, we should remain realistic and pragmatic. Exclusion is not the way forward because then a private equity fund or hedge funds will buy the assets instead. If we exclude all the oil companies, then we won't get the transition. The trick is to talk to them.

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