How to change the paradigm in finance to incorporate a changing environment

Climate change poses existential threats to global prosperity, but political and economic systems are unprepared for responding to that risk. Governance, incentives and thinking are still misaligned. The financial and corporate sectors could play an important role in turning the tide by truly managing for long-term value creation, i.e. by managing for positive financial, social and environmental returns in the long term – and be prepared for the transition to a more sustainable economic model. Unfortunately, current business practices are still too narrowly focused on short-term financial returns.

This problem seems even more severe in the financial sector. Institutional investors struggle to invest for long-term value creation. Traditional investment approaches, based on the neo-classical paradigm of efficient markets and portfolio theory, only capture financial value in their financial risk and return space. Attempts at sustainability integration are typically too shallow to overcome this problem. In our paper, and in our book Principles of Sustainable Finance, we examine the set of issues that make this problem so stubborn. We outline the contours of an alternative paradigm, based on adaptive markets, that is better able to pursue long-term value creation. It relies on active management in concentrated portfolios, with deep engagement aimed at assessing companies' transition preparedness.

From efficient markets thinking to adaptive markets thinking

The current orthodoxy of efficient markets hypothesis and portfolio theory say that securities are correctly priced given their risk profile. These theories pervade the language and thinking of asset management. Unfortunately, it makes blind to anything outside the financial risk-return space. Meanwhile there is plenty of evidence that markets are not always efficient and that this thinking is flawed.

A better description of markets is given by the adaptive markets hypothesis, which takes an evolutionary perspective: the degree of market efficiency depends on the learning and behaviour of individuals who are adapting to a changing environment. This can explain how new risks, such as environmental risks, are not yet fully priced in: not enough investors are examining these new risks, nor what they mean for long-term value creation. To assess that, one needs to consider the business fundamentals of a company and how prepared it is for a more sustainable future, including a serious internalisation of externalities. For example, an airline might make a €2 billion annual profit, but if its CO_2 emissions create a negative externality of €3 billion, this is not a viable model, and it will be internalised at some point. The adaptive investor is prepared for that shift.

From benchmark investing to real investing

Investing needs to become investing again. In a world of efficient markets, the decision where to put your capital is reduced to an econometric analysis of historical relations between financial return and financial risk. The fundamental risks of the companies in the portfolio or their value creation for society do not come into play. Instead of investing in a value creation path, investors buy an index or a deviation from an index. This passive investing approach seems attractive since it minimises visible costs (i.e. fees) as well as career risks for investors and consultants. But a reversal of this trend is badly needed: compared to passive investing, active management has superior potential for achieving long term value creation, provided that it employs concentrated portfolios and deep engagement. These two go hand in hand. Only in concentrated portfolios does an investor really know what he or she owns, and can thorough transition preparedness analysis be done: investors need to do labour-intense desk research and interviews, to understand how well prepared companies are. And only in concentrated portfolios is it possible and worthwhile to engage with all holdings for long term value creation.

From purely financial performance measurement towards steering on integrated value

Investment performance measurement needs to change as well. Social and environmental dimensions are typically not included, making their users effectively blind to these issues. While asset managers do track sustainability indicators, this is typically done as an add-on to financial numbers, not as a driver of value creation. This link can be made, though, as the impact report by Dutch bank ABN AMRO shows: it presents an integrated P&L with derivative statements that outline the bank's negative externalities and its value creation for specific stakeholders.

The role of asset management: from simple aggregation to real value added

In the current setting, the role of asset management firms seems limited to providing efficiency and aggregation. A much bigger role for asset management looms in a paradigm aimed at long-term value creation. The industry could then build trust and add a lot of value by stepping up its efforts in terms of the depth and breadth of transition preparedness analysis, its engagement, and the concentration of its portfolios.

Recommendations to achieve change

Achieving paradigm change requires a change of mindsets, for which we recommend the following:

1. Modernise finance courses at business schools and universities. These are still mostly taught from an efficient markets perspective, with little reference to sustainability or even behavioural insights. It would be a major step forward if students were taught in the spirit of our article and book in at least one of their finance courses.
2. Integrated regulation: Most corporate governance frameworks, corporate incentives and financial regulations are squarely aimed at financial performance and financial stability. Regulators' goals should be widened to include the prosperity and survival of the societies whose financial stability they are supposed to protect. Similarly, the financial industry should have a wider concept of fiduciary duty.
3. Corporate reporting on integrated value: companies should be required to at least report on their material sustainability issues, allowing analysts to better assess their transition preparedness. Eventually, companies should report on their full societal value, providing an integrated P&L and an integrated balance sheet. That road is long, and given the importance of context, it is probably wise not to standardise too early, as it would stifle creativity and innovation in reporting. At this stage, regulators are advised to require companies to answer a short list of simple but tough questions.

All this will take time, but it will force market participants to react and innovate. This is adaptation at work.

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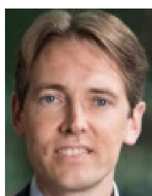

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