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## Bernhard Langer

Chief Investment Officer, Invesco

# Investing for sustainability-turning an art form into a science

Sustainability and responsibility in investments are on everyone's lips, with climate change and environmental protection enjoying high attention. The 2015 Paris Agreement marked a significant step as governments acknowledged that actions are required to mitigate global warming and the impact of climate change. While historically the assessment of ESG risks was considering more of an art form than a science, the increasing availability of quantitative data allows for controlling portfolio exposures towards sustainability risks both in dedicated ESG investment strategies as well as conventional ones.

While ESG is clearly a multi-dimensional problem, certain aspects are clearly salient drivers: the aggregated ESG score as well as the carbon footprint of a portfolio. Managing the latter leads to the limitation of two types of risks at the same time: the contribution of the portfolio to global warming as well as the risk of global warming to the portfolio. In a recent study, we compared a portfolio with explicit carbon management to another one lacking this dimension. The carbon-controlled portfolio aligned to the 2-degree Paris target, whereas the naïve portfolio aligned to 3.95-degree global warming scenario. Furthermore, the financial transition risk in a 1.5-degree scenario could be dramatically reduced from a portfolio impact of -5.1% to -3.4%.

Developing climate scenario analysis is a high priority for the financial industry and financial regulators in order to be able to measure forward-looking climate risks. The results are promising but the models are only as good as the data and assumptions that underpin them, where more work is likely to be needed. Ensuring access to reliable and comparable sustainability data is therefore essential to further these developments. Beyond climate, there is increasing evidence that other environmental and sustainability risks are likely to be equally relevant, both for the planet and for investors.

The coronavirus pandemic has served to highlight the issue of biodiversity and deforestation, as well as social risks. While investor awareness of these issues is increasing, we still have some way to go before the quantification of these risks reaches the same level of sophistication as for climate risks. Invesco Quantitative Strategies is convinced that a prudent risk management should include forward-looking environmental risks. We have developed a toolset to explicitly control the carbon emissions of a portfolio without sacrificing return expectations. Those techniques play a crucial role in supporting the Net Zero goal from a financial perspective. We expect that over time, this will evolve to cover other environmental and sustainability risks as the scientific evidence increases. ●