ESG Now Podcast

"What the Market Thinks: A Climate Risk Survey"

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Mike Disabato (00:00):

What's up everyone? And welcome to the weekly edition of ESG Now, where we cover how the environment, our society and corporate governance affects and are affected by our economy. I'm your host Mike Disabato, and this week we discuss the new survey out by the MSCI Sustainability Institute that looks at what investors, insurers and financial experts are thinking about the future of climate change and its impact on the global markets. Thanks as always for joining us. Stay tuned. What do financial market participants actually think about climate risk? Sure, most care that the world is warming and there may be ecological collapses because of that, but in knowing that, how are market participants reacting? Well, to answer to that question, the MSCI Sustainability Institute conducted a survey of more than 350 senior investors and risk managers across banks, insurers, and investment institutions with varying knowledge about climate change for their views on the trajectory of climate policy, the pace of the energy transition and the impacts of climate related hazards.

(01:12):

The survey was about 21 questions and of course it's public, so I'm going to link a copy of it on the pod description for you to review. But as a whole, it painted a picture of a market that sees the economic fallout caused by physical risks like floods and like hurricanes, and it sees those risks as being already here and already impacting them, but they are divided between market participants who expect global greenhouse gas emissions to peak soon and those who expect such emissions to grow indefinitely. Now, those are differing opinions that would reflect two different futures. So how do we get a market that is united on physical risks but divided on emissions? Well, to answer that I have with me today, one of the survey's main authors, Russ Bowdrey. Now Russ is an actuary and an actuary is someone who is a master translator between the highly technical and anyone that is interested in the highly technical and luckily he's also a colleague. So I could put him to work to help translate what this survey actually means in practice. And like any good translator, he wanted me first to pay attention to the context in which these market participants were answering, meaning what was the time horizon that they thought climate change was going to really impact their investments?

Russ Bowdrey (02:31):

One of the things that we observed in one of the profiling questions we asked in the survey was about people's decision horizons. So essentially, when they're taking their investment or risk management decisions, what sort of time horizon into the future are they considering? For the most part, that was of the order of one to five years covers the vast majority there. And we asked a separate question about climate risk horizon. So when you're specifically thinking about climate, how far ahead are you looking? And it was slightly longer, but in general, not much longer. So maybe if you said I think five years ahead, then you might be looking 10 years ahead for your climate risk. So how's this relevant to the pricing in thing? Well, for the most part, physical risk takes maybe 10 to 15 years for it to start to crystallizing into really scary stuff if we find ourselves heading in that direction.

(03:30):

And then potential policy impacts and changes of technology that maybe happens in the shorter term. But what it means is that you don't get a complete picture of what's being priced in. And when we say priced in, we mean that when somebody is thinking about the revenues of a particular company, they're projecting them forwards. They're doing something to adjust those revenues when they're coming up with their kind of hypothetical and then discounting it back. So arguably for equities and riskier assets, those discount rates are very high, and that means that the importance of events that are happening further out diminishes quite quickly. And actually it's very hard to observe pricing in of things because the only price you ever observe is a transaction. Fundamentally, you can see the order book, but usually that's not what's used when people are talking about pricing in and therefore the transaction happens at the highest bidder. But people who are taking into account say potential damages to the climate, they may be coming up with a valuation for a asset or stock or whatever that might be a bit lower than that, and therefore then they're not going to win that auction. So I think that's another element that muddies the water significantly.

Mike Disabato (04:50):

Right? So if you're one of the 48% of respondents that said financial assets don't reflect the real impact of climate risk and you're in a bidding war with someone that thinks the assets are fairly priced or at least partially priced, which was 41% of the respondents you're going to drop out of the race, aren't you? And the price of that asset will remain maybe too high depending on who you ask. Now, the reason for this divergence, this barbell type of response might be due to differing time horizons. As Russ noted, the short-term decision horizon of a certain investor at one to five years might be coming into conflict with a relatively longer term serious impacts of climate change at 10 to 15 years. Except if you're someone that thinks the climate change is here already and that one to five year time horizon is already being hit. But that divergence between the one to five year, the 10 to 15 year, the 30 to 40 year, just the divergence between market participants is to be blunt, a boon for the savvy minded investor.

Russ Bowdrey (05:52):

This really came out when we were discussing with an expert at New York Climate Wheat. So one of the attendees was from a major investment bank, and we were sharing the graph, which is all about when the respondents think that global emissions are going to peak, and there we see this big bifurcation of roughly 40% saying it's going to peak very soon, and roughly 40% saying it's never going to peak. And this gentleman's observation was, well, that sort of diversity and view is where we generate alpha, where we generate outperformance because somebody's going to be wrong.

And that diversity of views also feeds into then what those different populations of people will value in a stock. So somebody who thinks that emissions are going to increase indefinitely are going to more highly value stocks that benefit from that, and they will undervalue things that maybe benefit from peaking earlier and vice versa.

Mike Disabato (06:51):

If the market were pricing in the risks and opportunities due to climate change effectively there would be no potential for outperformance. But people think there are. And since there are differing opinions on the matter, then there must be more opportunities out there for undervalued or overvalued assets. Okay, so moving away from the anecdote and into the survey numbers, we saw that more than two thirds of respondents said that they expect oil companies to underperform the market as a whole over the next 10 years as the world works to move away from carbon intensive operations, while a bit more than 50% said they expect companies in the aviation industry and half of the firms in the industrials sector to underperform, that means that 50% thinks that companies in the aviation industry and half the firms in the industrial sector is going to outperform. Who's going to be right?

(07:40):

We don't know yet, but really the question of what you think your asset will be worth in the future probably depends on how hot you think the future is going to get. So the survey asked respondents what they think the global temperature will be like in 2100. And depending on how you answer 1.5 degrees, two degrees, three degrees, all that will give away how much effort you think the world is going to give to lower its emissions. And you're probably going to invest differently depending on how hot you think the world is going to get since some regions and some assets will probably benefit from a warmer world and some will be surrounded by hell fire.

Russ Bowdrey (08:18):

So we asked what's the most likely temperature increase by 2100, which is still a long way out. And what we saw was mostly in line with a survey that the guardian newspaper in the UK ran where they asked 300 odd climate scientists, all of whom contribute to the international panel on climate change what they would answer to that question. So our central measure, the median came out to be roughly the same, but what our investor and risk manager respondents were indicating was a much wider, much more divergent view. And in fact, in terms of catastrophic world above five degrees, there are many, many more than this climate scientists. This question, what's the linkage between temperature rise and economic impact? And here we were really trying to get at what's your view on how climate change propagate through the economy? And what we saw was a big chunk, so roughly 40 to 45% of respondents saying that a world where total economic destruction is plausible, that's significant.

(09:31):

Playing out these scenarios, which I think a lot of asset owners, particularly the highly regulated countries, are being coached towards by their regulators. They're playing through their war gaming. And what do they do as a result of that? Well, they're preparing themselves. So investors in Canada are buying up land and buying up real estate because they see that actually their farming land is going to become more productive and that they may well be the net recipients of significant climate driven migration, which was one of our other questions. So there's opportunity in there as well as risk if you're in the right places. So then comes down to then having the right tools to identify those opportunities, understanding the size of them.

Mike Disabato (10:16):

What we've seen so far is a picture of uncertainty that Russ has painted for us with investors assessing both risks and opportunities and a climate that is changing. Many are preparing for the worst case scenario, buying land, adapting portfolios and war gaming for possible economic impacts. But at the same time, the survey found that this continued belief that we will be able to adopt our way out of the problem of a warmed world. And that's where the conversations sort of shift. When I was talking to Russ, while some investors are deeply concerned about the physical risks and potential devastation caused by climate change, there's also this overwhelming sense that humans can adopt to anything that is thrown at us.

Russ Bowdrey (10:57):

So I think as investors give a lot of credit to industry and humanity as a whole to adapt. So whilst there was a deep concern about physical risk and its ability to potentially devastate economies, there was also this optimism that actually humanity as a whole can adapt its way out by technological means through increasing the resilience of cities to extreme weather events. Now, reading between the lines, it would be really fascinating to see whether that view differed between say, developed markets, big cities, emerging markets, small settlements, that's where the color comes in. But as a whole, I saw that as another example if you like, of a barbell. So we saw this barbell in terms of the emissions peak soon versus never peak, but also this barbell in terms of yeah, I'm very concerned about physical risks, but I also hold out this hope that we'll model our way through.

Mike Disabato (12:01):

Now, those efforts do require a significant amount of investment. The required amount is usually said to be in the trillions or something so large that your mind wanders off the minute I say it. And so to be more concrete, France has actually been one of the more vocal developed market governments on the need for pouring more capital into adaptation efforts like preparing for more extreme floods and the like. It has allocated around 30 billion euros for the effort to prepare for the worst case scenarios of global warming, which some have seen as pragmatic, but others have criticized the French government of surrendering to the reality of climate change. But if I have to be honest, when looking at the survey results, France is very much not alone here. One of the more surprising findings in the survey was in how market participants viewed corporate commitments net zero, which many including ourselves have been very vocal on over the past half decade. But survey responses revealed that a sizable majority of respondents are doubtful 41% or highly doubtful 28% of the likelihood of achieving global net zero emissions by 2050. So I asked Russ about this because that seemed like a pretty surprising response to me by a market that has a lot of companies in it which have embraced net zero.

Russ Bowdrey (13:13):

I think that there's a couple of things here. So firstly, achieving net zero by 2050, that's all about getting emissions below a particular point to net zero. But that is actually quite different to achieving a particular temperature outcome by the end of the century. And yes, they are closely linked, but actually because our understanding of the science is it's so complex that we can't necessarily be sure that even if net zero is achieved by 2050, we can't be sure what temperature ends up there. But one thing it drives home, and I've discussed with many colleagues over the last couple of weeks is it drives home that the need to help inform better our clients around the need for the transition to progress as quickly as possible and for us to give the tools for it to happen has never been greater. And at the same time, we need to be realistic that we also need to inform the building of resilience and the information to understand where things can start going wrong. So it's hoping for the best, but planning for the worst continues to be the same, but we can't give up hope because sometimes hope's the best thing to keep you going.

Mike Disabato (14:25):

Optimism aside, well, not aside, I need optimism, I want optimism. But still, optimism aside, what this survey is, is a view into how investors perceive future climate scenarios and how they're preparing for potential outcomes. They hope the authors hope the study will help participants across the financial industry benchmark their strategies to the broader market with the information that they've given them. And policymakers can see it a way to understand how capital market participants envision our climate future relative to policy defined climate scenarios already in use. How are people thinking and reacting to climate policies that are in place? And yes, we are all unfortunately part of a science experiment at the moment with this warming world. So the picture that this survey paints is going to change. New technologies will come about as will new policies and things of that sort. But one thing is likely the rapidly warming world that investors envision today will ultimately trigger investments in innovations that change the trajectory of our climate tomorrow. And depending on what type of investor you are, you'll either be looking for those or you might see those pass you by. And that's it for the week. I wanted to thank Russ for talking to me about the news with a sustainability twist. I wanted to thank you so much for listening. If you like what you heard, don't forget to rate and review us and of course, subscribe wherever you get your podcasts. So you can hear myself, Bentley or any of the other ESG now co-hosts every week. We're off next week for Thanksgiving, but the week after that I'll see you. So talk to you pretty soon.

Speaker 3 (16:22):

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