AGF SUSTAINABLE

MARKET INSIGHT

The Most Important Chart in Sustainable Finance?

By Martin Grosskopf and Andy Kochar

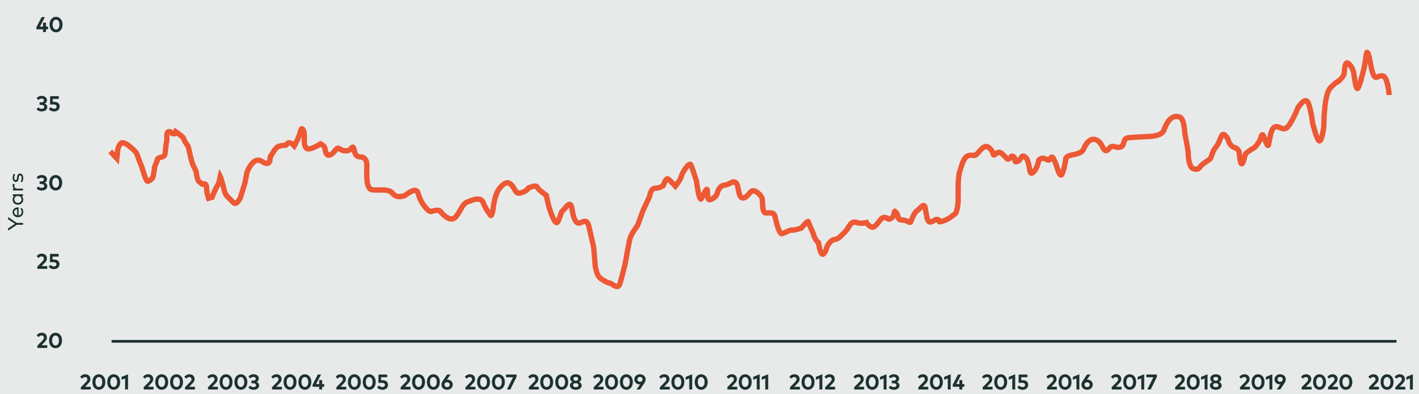
A great deal has been written in the last few years about the rise of sustainability in the financial sector – often either on sustainability itself (corporate or policy objectives) or on the opportunity and risks for financial markets (stock prices and fund flows). As we all know, the COVID-19 crisis accelerated this movement, with sustainability-linked products taking the lion's share of new fund flows, and with many sustainability-linked themes significantly outperforming in 2020[1].

However, 2021 has brought some significant rotation away from companies with the most to benefit from capital inflows and the most to offer over the long term – for example, pure EV and battery companies, renewables, and so on. The question on many minds is whether this is the pause that refreshes or the initial signs of a longer-term shift in direction. The answer lies in how the concept of duration applies to the market – and "sustainable" assets, unfortunately, will not be immune from this cruel taskmaster.

All financial assets and in fact all investment theses have some aspect of duration embedded in their valuation and premiums. For equities, duration can be considered as the time it takes to recoup one's initial investment through future cash flows. An estimation of today's equity market duration is provided in *Figure 1*. The idea is that long-duration equity investments have a significant proportion of their intrinsic value tied to their terminal value, thereby making them susceptible to drawdowns when interest rate volatility picks up on a cyclical basis.

As one can see from this estimation, the duration of the U.S. equity market has until very recently been increasing since the Great Financial Crisis, thanks to falling interest rates and the significant, growing presence of long-duration sectors such as Information Technology and Health Care. On the other hand, although the fixed income market has had its share of duration extensions as well, S&P 500 equities have stretched to a duration of 35 to 40 years (see below). Global bond market duration[2] is only around 7.5 years, up from six years almost a decade ago.

Figure 1. S&P 500 Duration



Source: BofA U.S. Equity & Quant Strategy

[1] Source: RBC Capital Markets, Morningstar, as of December 2020.
[2] As represented by the Barclays Global Aggregate Bond Index, as of June 2021.

This has a number of important ramifications:

1. Most sustainability themes are quite long-term in nature. Take climate change as an example. Governments and companies have begun to make serious 2050 commitments to reduce carbon emissions to levels that would ensure global temperatures do not rise above 1.5-2.0° C. Similiarly, objectives around the United Nations Sustainable Development Goals often tie into reducing negative environmental impacts or reducing poverty long-term. The European Union's Green Deal focuses on redirecting capital towards greener enterprises over decades. As such, the very nature of sustainability themes is a focus on the long term, and as a result these are essentially long-duration issues. It is no surprise, then, that asset owners are leading the charge towards sustainability, given that their liabilities run into multiple decades, if not indefinitely.

2. Most companies with the best exposure to sustainability themes – those in the renewables and EV supply chains, for instance, or those focused on issues in sustainable agriculture or the circular economy – are also by nature long-duration. They are often capital-intensive, investing today to provide the products and solutions needed over decades to meet sustainabiltiy objectives. Without this focus, we simply will not meet the aspirational targets being set around the world.

3. As with any long-duration investment thesis, much depends on the discount rate. As this rate moves up (yields in the market reflecting inflationary concerns), investors are less and less willing to focus on the long term and instead seek predictability in the very short term. This rotation creates a fairly dramatic reassessment of any long-tail growth opportunity, whether it is sustainability-focused or not. As one can see from *Figure 1*, should inflationary concerns remain the primary consideration of markets over a prolonged period, there is significant risk to further decline in equity duration to the benefit of such highly cyclical sectors as mining, oil and gas, and financials.

4. Prolonged rotation away from growth would ensure that the cost of capital for companies at the sharp end of sustainability (those that are "pure play," with high investment levels) would suffer relative to those that benefit from reflation – usually commodities-related companies. We have already seen rotation towards highly cyclical names with new "transition" commitments, as the market values the near-term cash flows highly and the companies benefit from a "wrapper" of sustainability pledges.

The Next Stage of Growth in Sustainable Finance – Mobilizing New Sources of Capital

The adoption of ESG principles under the UN Principles for Responsible Investing (PRI), as well as sustainability objectives more generally, began to increase significantly afer the Global Financial Crisis (2009 and onwards). Not surpisingly, this increase has been highly correlated with the improving outlook for long-duration assets over the past 10 years. As we have witnessed many times over the years, a rising interest rate environment does not derail the upward trend simply because the financial benefits of these investments (earnings, cash flow growth and so on) far outweigh the rise in discount rates. Further, interest rate volatility spikes are transitory, at most, and they have often tended to be good buying opportunities. The market in 2020 expressed remarkable exuberance for long-duration assets, with the launch of many early-stage companies as special purpose acquisition companies (SPACs) – sometimes with little revenue let alone cash flow, but within important sustainability sub-themes. This was clearly unlikely to continue at the same pace.

The renewed focus by governments and the private sector to drive the sustainability agenda has resulted in a call for mobilizing various sources of capital with varying degrees of duration. Given the low level of interest rates, one can make a promising case to accelerate this transition by issuance of government, development, corporate bonds and other credit instruments of various maturities/durations. Yet while the practicality of using these instruments is obvious (for example, green bonds), one cannot ignore the fact that funding long-term sustainability objectives projects with shorter-duration debt comes with both benefits and limitations.

Benefits

- **Offset equity duration:** Cyclical volatility of interest rates can be effectively countered in long-duration equity portfolios with shorter-duration fixed income instruments, thereby reducing the duration of the aggregate portfolio.
- **Access to capital:** The flow of capital, as a result, does not need to be interrupted simply because of certain macroeconomic factors that are causing temporary disruption. After all, the sustainability transition is a long-term objective.
- **Staying invested in themes:** Investors can focus on the broader objective of staying invested within these long-duration themes without having to gravitate towards short-duration sectors such as energy and financials, whose contribution to long-term sustainability objectives is questionable.

Limitations

- **Quality of capital:** As much as governments and corporations around the world continue to make strides toward a more sustainable future, the flow of capital in many places is in the form of term debt. Sustainable transition on the back of excessive financial leverage can result in the financial system (and more importantly its players) becoming more vulnerable to external shocks. The next few decades of investment cannot hinge on more debt, but rather on more permanent forms of long-term equity capital, as has been the case with large asset owners.
- **Duration of invested capital:** Duration can be a double-edged sword and hence must be managed actively. To focus on attaining long-term objectives, full-cycle investing must be funded with long-duration capital and, more importantly, higher-quality capital such as equity. If long-term projects are excessively funded by too much short-duration term debt, the results may be an uncomfortable duration mismatch. For example, one can expect periods of market and macroeconomic volatility which, should they last for several quarters, can entail difficult windows for refinancing. In other words, to earn a healthy return on invested capital and, more importantly, to attain long-term sustainability objectives, long-duration capital is critical.

The critical question for meeting longer-term sustainability objectives remains whether the latest rotation away from growth and into cyclicality is temporary or more long-lived, and how the sustainable finance sector responds. It is clear that talk of "supercycles" in carbon-intensive industries will run headlong into the challenge of ensuring a "supercycle" in carbon reduction solutions. Providing long-term capital to companies making the required investments in those solutions is at the heart of sustainable finance, but nothing gets to the heart of actual capital flows more succinctly than duration.

Martin Grosskopf

Vice-President and Portfolio Manager,
AGF Investments Inc.

Andy Kochar

Vice-President, Portfolio Manager
and Head of Global Credit,
AGF Investments Inc.

AGF®

For more information, visit AGF.com

Publication Date: July 7, 2021. RO: 1699339/1721278

FUND1229-07-21-E