

PRIMER: How investment works and how it can help or hinder the transition



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PRIMER: HOW INVESTMENT WORKS – AND HOW IT CAN HELP OR HINDER THE TRANSITION

This guide is intended to serve as a brief introduction to responsible investment for policymakers who are new to or unfamiliar with the topic.

“[T]he private sector has the ability to find solutions to climate change by funding the trillions needed for a global transition to clean energy” said US climate envoy John Kerry ([CNBC, 2021](#))

– why then, is that not happening?

This short primer is intended to support policymakers in understanding what responsible investment is, its potential, and its limitations.

INTRODUCTION

Responsible or sustainable investment is a generic term that has a range of interpretations.

For those new to responsible investment, responsible investment is typically understood as ‘impact investment’ – talking trivially, “investing in wind turbines”. Impact investing can be defined as “Investing with the intention to generate positive, measurable social and/or environmental impact alongside a financial return” ([CFA Institute, GSIA, and PRI, 2023](#)).

While impact investment is an important part of responsible investment, it is but a subset of investable capital. For impact investors, the objective is to invest in projects, assets and companies that provide demonstrable real-world impact.

However, most institutional investors (this includes pension funds, insurance funds and mutual funds) are subject to a range of constraints that limit the impact of their investment. This may include ‘fiduciary duty’, a set of legal and ethical obligations in which institutional investors must act in the best interests of their beneficiaries (depending upon interpretation).

These investors – managing trillions of dollars in total – invest in listed assets (the day-to-day brands we’re familiar with as consumers, such as Apple or Coca Cola) as well as government debt.

THE INTERMEDIATION CHAIN

To understand responsible and sustainable investment, it’s important to first understand the intermediation chain – the chain of ‘actors’ that connect providers of capital (savers, insurance policy holders, in short, us as individuals) with users of capital (companies and governments). There are a number of ways in which individuals interact with the capital markets (often, without even knowing about it), such as through:

- Pension funds
- Insurance funds
- Mutual funds
- Banks, private wealth

In aggregate, these investors are called asset owners. In some markets, they are well resourced, for example, the Dutch, Australian or Californian pension markets are characterised as large, well-resourced pension funds. In some markets, they are more fragmented, such as the UK (although this is changing through auto-enrolment).

In turn, asset owners invest via asset managers. Asset managers take many forms – the largest, such as Blackrock, Vanguard or State Street, invest trillions of dollars on behalf of their clients. Smaller asset managers may invest a few billion, or even few hundred million dollars.

ASSET CLASSES

Companies are typically financed through equity (the company's ownership) and debt. Equity can be private or public; where public, the company is listed on a stock exchange, and anyone (in theory) can purchase the company's shares.

Investors assume a certain amount of risk (that the company is unsuccessful). In return, the shares may increase in value (if the company is successful), and the company may pay its shareholders a dividend.

Debt tends to be structured as a bond, an investment with a fixed coupon, over a fixed time period.

Public equity, public debt, private equity, private debt, and potentially, infrastructure and property may all form part of an investor's portfolio.

LEVERS OF INFLUENCE

There are two main approaches that investors can take to achieve their sustainability goals:

1. They can invest (choose not to invest, reduce their investment, or divest entirely).
2. They can engage (as a (part) owner of a company, the investor has certain engagement rights, such as participation in the company's annual general meeting (AGM)) and can use their influence with other stakeholders, for example, policymakers, NGOs and civil society.

Key term: Stewardship – “The use of investor rights and influence to protect and enhance overall long-term value for clients and beneficiaries, including the common economic, social and

environmental assets on which their interests depend.” ([CFA Institute, GSIA, and PRI, 2023](#)).

Companies will respond in different ways, depending on the company's position, the 'ask', and the type of investor.

As such, investors' contribution to net-zero GHG emissions (net-zero meaning amount of GHGs emitted to the atmosphere equals GHGs removed) may involve direct investments in sustainability solutions, but more likely, it will involve investing and engaging companies on their own corporate decision-making.

OPPORTUNITIES IN INVESTMENT

Runaway climate change is not in investors' best interests.

As such, investors have both the motivation and the means to take action to address climate change. However, the route to doing so is often indirect, more complex than is typically understood, and subject to barriers that can be technical, and multi-departmental.

Barriers include:

- Lack of policy progress in the real economy (investors' portfolios will often mirror that of the economy).
- Lack of investable environmental solutions (at market rates of return).
- Misinterpretation of legal frameworks, such as fiduciary duties and acting in concert.
- Inadequate disclosures of companies' sustainability activities.
- Inadequate expertise and resourcing.
- Short-termism and short-term reporting requirements.

Lifting these barriers will enable capital to flow (both investor capital, and capital within companies' own balance sheets, subject to investor oversight) to sustainability solutions at pace and scale, accelerating the transition.

This is why a 'systems' and 'whole-of-government' approach is needed to ensure – as John Kerry set

out in 2021 – that the private sector funds the trillions needed for a global transition to clean energy.

FURTHER READING

Global Sustainable Investment Alliance, CFA Institute, & Principles for Responsible Investment. (2023). *Definitions for Responsible Investment Approaches*. <https://www.gsi-alliance.org/members-resources/definitions-for-responsible-investment-approaches/>

Global Sustainable Investment Alliance. (2022). *Global Sustainable Investment Review*. <https://www.gsi-alliance.org/members-resources/gsir2022/>





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