COMMENTARY

Michael Frerichs: Climate change poses financial risks. Why would officials want investors to ignore that fact?

By Michael Frerichs
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Institutional investors, be they state treasurers managing funds for public safety and education or asset managers running mutual funds, are responsible for protecting and growing other people's hard-earned savings.

To carry out this responsibility, institutional investors use a highly disciplined process to regularly assess the risks and opportunities facing the companies and other assets in their portfolio.

That ongoing risk and reward analysis is what the investment industry is all about. That's why there are whole subfields of analysts who study the short- and long-term horizon of the economy, the fluctuations of specific industries and the growth prospects of individual companies. And as part of that responsibility, institutional investors, such as large asset managers running mutual funds or state treasurers managing public funds, are legally required to identify risks that can pose material harm to returns.

So, it's baffling why some officials around the country appear to want to skip this professional responsibility by banning investment managers and banks that consider the billion-dollar risks related to climate change, environmental degradation, water shortages and poor company governance.

Floods, hurricanes, drought and heat waves continue to sweep across the U.S., taking lives, disrupting power and supply chains, and causing hundreds of billions of dollars in losses in destroyed crops, abandoned farmland, ruined factories, office buildings and homes. We have to wonder why an investment manager or institutional investor would want to ignore these risks — or on the other hand, ignore opportunities to invest in companies well-positioned for sustainable, long-term returns.

Last year, extreme weather disasters resulted in 474 deaths and cost upward of $165 billion in damages, according to the National Oceanic and Atmospheric Administration. That is just one year in the U.S. The heat wave that swept through the Midwest and West cost $22 billion, affecting farmers, businesses and communities in Illinois. As the years pass, we're seeing ever worsening droughts, floods and storms. Illinois ranks fourth in the country in the frequency of billion-dollar extreme weather events, which have created more than $38 billion in damages since 1980, according to the Illinois state climatologist and the NOAA.

Climate risk is financial risk. That is a cold, hard fact. To ignore it would be a dereliction of duty.

Then there are the risks that companies face from poor corporate governance practices such as ignoring workers' health and safety or allowing forced labor in supply chains or neglecting the harms that a product can inflict on consumers. Such risks can lead to costly lawsuits, increased regulatory scrutiny and declining revenues as customers and employees, including potential employees, are turned off by such behavior and choose to go elsewhere. In other words, social and governance risks can be financially material as well.

Most institutional investors today understand the importance of climate and other sustainability risks on financial performance. That's why there's been such growth in funds that integrate sustainability factors — to the tune of an estimated $37.8 trillion by the end of 2021, according to Bloomberg, which forecasts investing in sustainable assets to grow to $53 trillion by 2025.

It's not just about risk. Investors also see the money to be made in innovative technologies and sustainable business solutions — in the huge growth in wind and solar installation, in modernizing and making the energy grid more resilient, and in expanding production of electric vehicles, for instance. Investment in clean energy and related technologies surpassed $1 trillion last year, according to Bloomberg, matching for the first time, investment in fossil fuel energy.

In the U.S. alone, assets under management using sustainable investment strategies rose to $17.1 trillion at the start of 2020, already a third of all professionally managed assets in the U.S. and representing a growth of 42% in two years from $12 trillion, according to US SIF, a nonprofit that advances sustainable and responsible investments.

But it is not the fast growth of sustainable investing that attracts Illinois to it. We believe in investing funds for long-term growth as well as short-term availability. That's what our clients and beneficiaries — the families saving for college and retirement and the towns and businesses planning out capital expenditures and ensuring public safety — depend on us for.

In Illinois, we take pride in our success protecting the state's portfolio, stewarding the money of local governments, helping working families become more financially stable and consistently producing earnings at or above industry standards.

To ask our investment professionals to ignore fundamental risks and opportunities or to ban financial institutions from considering all the risks looming over our economy and their portfolios, would only hinder the prospects for generating strong returns. A study by the Wharton School of the University of Pennsylvania and the Federal Reserve Bank of Chicago showed this is happening elsewhere, costing taxpayers hundreds of millions of dollars, when state legislators interfere with the free flow of capital, blacklist financial service providers and reduce market competition.

As I and a group of fellow treasurers from states across the country wrote in a letter last year, "This type of short-term thinking imposes an ideological screen on an investment manager's ability to perform or whether an investment banker can compete for the opportunity to underwrite debt. This screen negatively impacts competitive costs and increases potential risks that will be left for others to deal with in the future. In the case of state and public pension funds, these losses will be borne by the taxpayers and that means all of us."

Given my fiduciary duty as treasurer of Illinois, I would not want to risk beneficiaries' hard-earned savings or state coffers on investments where such multibillion-dollar risks are disregarded.

Michael Frerichs is the state treasurer of Illinois.