BEYOND BLACK & WHITE INVESTING

Viewing the evolution of sustainable investing through a coloured lens.

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Executive summary

Whilst the relevance of sustainability to investing is widely accepted by all actors along the investment value chain, its implications on their corporate strategy has yet to be fully appreciated. To illuminate the vast magnitude, profound implications, and requisite agility for leaders in adapting their strategies, we draw parallels from the film industry's transition to colour during the 1940s.

A century after Technicolor's™ three strip photography revolutionised how the media industry enables us to see the world, sustainability, digitalisation, and decentralisation are structurally changing the way our investments shape it. We view ESG as a "colour lens" through which all investments are perceived, rather than a growing niche bursting onto the mainstream getting bogged down by disclosure regulations.

The foremost challenge for asset management executives lies in determining when business model transformation supersedes reactive short-term adjustments. The growth of their assets, returns, retention, profitability, and resilience hinges upon this critical decision, particularly amidst a sea change in the macro, geopolitical, regulatory, and digital landscapes. We often see the first steps being taken as a reaction to client demand and regulatory compliance. It is unsurprising that the "ESG talent" that emerges has been skewed towards those disciplines rather than the investment professionals entrusted with deploying capital. To bring some clarity to this, we delve into a recent case study we wrote for the PRI Academy to extrapolate how financial returns, real world impacts and the risks of "stranded liabilities" are of more pressing concern than the threat of being labelled as "greenwashing". **The 1940's were unkind to those studios that could only contend with black and white films.**

Most firms may choose to limit themselves to adapting to an 'outside-in' approach. This may be just enough to stay in the game by avoiding avoid irrecoverable losses. The "single materiality" approach to integrating ESG is a basic evolution for all investment activity that will leave laggards facing existential business risk. Getting ahead and gaining market share requires a "dual materiality" approach which is nothing short of revolutionary, particularly when it comes to redesigning investment strategies, business models and resource allocations. Most notably thanks to the evolution for how data is used.

These are exciting times for designing new fund launches, GP stakes, seeding, and even fund incubation. Particularly considering the distinct transmission mechanisms available within the alternative investments industry.

Just as ESG data adds colour to the scrutiny of individual assets, implementing appropriate frameworks into the investment lens of portfolio managers and fund allocators higher up the value chain expedites industry-wide adoption.

The key to unlocking this potential lies in answering the pivotal question at the heart of this scrip: "Where does subjectivity truly lie"?

Author
Joseph Naayem, CFA
joseph.naayem@kalmus.capital

They are not called "colour movies" anymore. We will not call it "sustainable investing" for much longer.

The first 'coloured' film was by Georges Melies who captured imaginations when he hand-painted "Trip to the moon" (1902) frame by frame. It then took over 30 years for the first Technicolour™ movie to be profitable after winning an Oscar (La Cucaracha, 1935).
Meanwhile, colour was ignored by the "Big Five" studios as an expensive and impractical "gimmick" leaving pioneering upstarts to change things.

Sustainable Investing is not new, neither is the controversy and confusion surrounding its interpretation and implementation. Recent exponential growth may have surprised mainstream financial institutions. Many rushed to adapt by painting over their portfolios with environmental, social and governance metrics. Patience for such "greenwashing" is wearing thin amongst investors and regulators alike.
We argue, that the scale of the systemic change underway remains grossly underestimated. Asset Manager Investment strategies, entrenched in organisational structures that evolved out of a black and white, risk and return world, are not prepared for the major disruptions ahead.
This paradigm shift is widely attributed to being forced by global disclosure regulations and rapidly changing investor appetites. However, as with the film industry's systemic transition to colour in the 1940's, technology; standardisation, and incentive structures are at the root of this acceleration.
History will be unkind to those that evolve incrementally, constrained by short term "budgetary decisions". It is time to be bold in redesigning asset management solutions and fund allocation approaches. Much like Technicolor™ revolutionised the way we see the world, we think of Environmental, Social and Governance (ESG) considerations as a lens through which all investment activities are perceived, rather than an exponentially growing separate category. They are not called "colour movies" anymore, we expect we will not call it "sustainable investing" for much longer.
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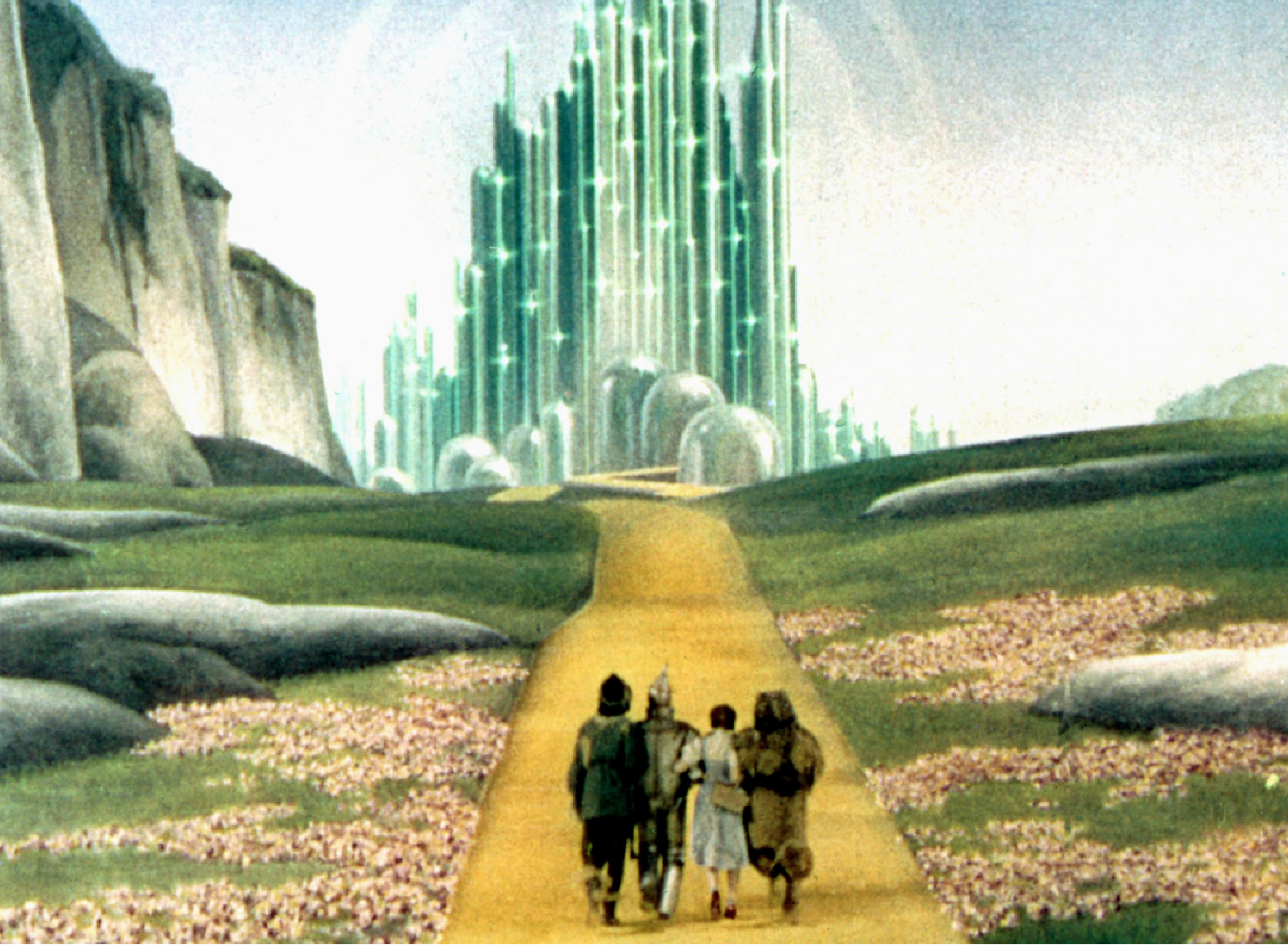
At a high level, explaining the concept of taking ESG factors into consideration in an investment process is as easy as describing the importance of superimposing three primary colours when capturing and diffusing an image. At a more granular level, the subtlety, context and dynamic inter-relationships between various ESG data points, is as complex as the full spectrum of the rainbow that is needed to visualise the world around us.



The growth of Sustainable Investing will be driven by the fear of negative returns rather than magical storytelling.

Sustainable investing may have started as a way of aligning moral values, but mobilising mass adoption requires efficient tools for this to credibly create real value.

Louis B Mayor remained the most sceptical of the majors, yet MGM made movie history with "The wizard of Oz" (1939) for its use of colour, showcasing Technicolor™ It became the most watched film of all time. It takes us from a depression era Kansas, filmed in washed black & white sepia transporting Dorothy to the magical land of OZ filmed in bright Technicolor. Much like the financial industry in the 2020's, once the 1940's kicked in, the performance of every studio executive was based on how well they shifted their strategy to integrated colour. ™

This was not a film that could have been made without colour. From the red ruby shoes to the yellow brick road Dorothy and her companions took to the Emerald city, the entire plot would have been nonsensical if shot in black and white. The emergence of ESG data in a similar way helps us create a new script for how funds can be created to focus on outcomes rather than purely financial metrics.

"you don't want Oz to look real. you want it to be in Technicolor"

Ken Fox, George Eastman Museum

Regulators are using the threat of litigation to ensure that perception is responsibly managed. Whilst this is critical to preserving trust, it should enhance, or at least not detract from how fund managers are equipped to manage actual performance. Valuable change is coming from digitalisation, machine learning and AI. These have accelerated innovation in ESG data and analytics tools over the last four years. Analysts are being equipped to significantly deepen how they scrutinise potential investments and market pricing is reflecting this.

Just like any other traditional financial dataset, directly relevant sustainability attributes; unique to each company; are increasingly being priced in by the market. Integrating ESG means doing so at every step of the investment process: from shaping how ideas are sourced, screened and compared, to how every line item of a valuation model is adjusted. Like the use of colour in various stages of a production, different sustainability considerations shape portfolio construction, risk management and engagement priorities

The scale of process adaptation required is a world apart from an incremental quick fix, by only relying on a separate "ESG team" to average out unrelated data points to narrow an investment universe to "acceptably" rated names. Investment houses whose culture may be skewed to short term incentive structures may find themselves left behind. This is partly due to the distraction of having to defend boastful claims that would inevitably fall under increasing scrutiny. The drain on resources from having to focus on client perception is a minor factor compared to the real damage made to track records from managing their assets inadequately. **The real liability faced by investors, is the cost of poor investment decisions made by colour blind managers, who assume we are still in a black and white market** as the macroeconomic landscape changes. There is no shortage of examples of ESG linked financial losses. To better illustrate the amplitude of the required shift to a coloured lens, we take a deep dive into the complexity of a real-world case study to then extrapolate the higher level strategic implications for Asset Managers, Allocators and Service Providers along the investment value chain.

Case Study: Vale and "Stranded Liabilities"

The following draws from a more detailed case study this author wrote as part of a PRI academy training module created in partnership with Contrast Capital.

Background:

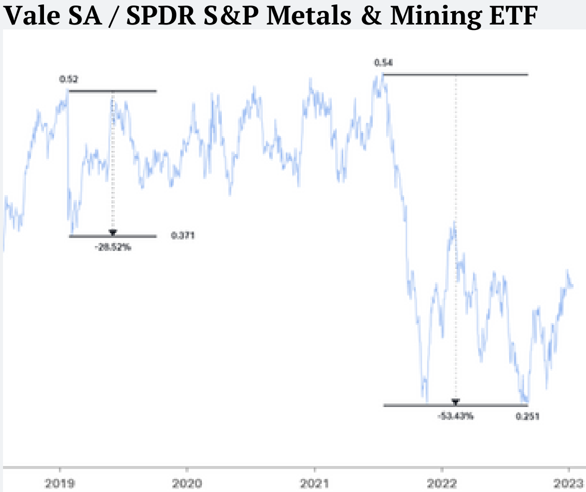
Since 2021, Vale, the Brazilian mining giant has enjoyed a flood of "buy" recommendations from analysts citing it as the cheapest amongst its mining peers amidst an inflationary cyclical upswing. Whilst ESG ratings were poor this was only integrated at a cosmetic level by most analysts, often not going much further than an adjustment to the cost of capital assumptions. Traditional black and white financial metrics dominated the narrative. Most notably: rising commodity prices, increased demand for iron ore, cheap valuations and the resolution of the claims following the 2019 Brumadhino Dam tragedy that killed 270 people. This incident exposed the dangers of lower cost uphill tailing dams and how material these risks are in having adverse real-world impacts as well as the scale of financial loss. This incident alone cost Vale over $7bn, which is equivalent to their 2018 net income. How these drive valuations however may still not be adequately reflected by the market.

The challenge with breadth:

There is a wide breadth of challenges facing mining companies: Safety, transition pathways, treatment of indigenous communities, biodiversity risk, board independence and a host of other material ESG issues are all highly relevant. Discerning the materiality amongst this rainbow of issues and their interdependence is challenging enough. The real art lies in how each translate them into different valuation adjustments in the context of each company. This is too complex to be separated out into a different part of the investment process by a different team. Especially if that team is under-resourced and may be tempted to aggregate their deliverables into one rating that is simpler to track internally.

The Brumadinho incident was instrumental in triggering impressive engagement efforts from asset owners, most notably from Nordic institutional investors. However, it became evident the market was not pricing this in when a mere rumour of another potential Dam collapse triggered a subsequent -53% fall in the stock relative to other mining peers. A government audit revealed that the decommissioned Xingu dam was at "imminent risk of collapse"

Vale SA / SPDR S&P Metals & Mining ETF



The relative price performance shows the -28% underperformance following the Brumadinho Dam tragedy in 2019 and -53% after rumours of another impending Dam break following a government audit of the Xingu dam in the same region.
Source: Koyfin.

The need for depth:

It would have been challenging for analysts / portfolio managers that cover over twenty companies to go to the required depths of analysis for a more contextual understanding of each potential issue. Although new AI tools may help, more resource intensive research may be warranted to adequately integrate this into their valuation models. Let us take just one issue regarding their tailing mines: Vale has over thirty other uphill tailing mines in Brazil that it needs to de-characterise. The associated costs may not be easily assessed, nor adequately disclosed. Whilst this is problematic, it is not exceptional. Where the real complexity comes in is in evaluating the timelines and adequate execution of addressing them compared to the probability of another incident occurring given the changes in microclimates. When a single mine collapse like Brumadinho ended up costing the equivalent of an entire year's profit, contending with a simple cost of capital adjustment is woefully inadequate.

Stranded liabilities:

From a credit analysis perspective, it has taken time for the market to start reflecting "stranded assets" on the balance sheet of fossil fuel companies. It may take some time yet for them to account for "stranded liabilities" from assets that don't even appear on the Balance Sheet.

Traditional black and white models are not adapted to account for non-productive legacy assets, such decommissioned mines, whose last ounce of Iron Ore was shipped to China over seven years ago. The fact that Vale is still being sued by the SEC for misleading disclosures, underscores the difficulties that even credit rating agencies may have in ascertaining the size of such stranded liabilities.

The rise of ESG litigation highlights the urgency for analysts to sharpen their investment lens. It is no surprise that Vale took advantage of low rates to push out the maturity of 80% of their debt till after they are supposed to have completed their mine de-characterisation program by 2027. This would be less of a concern if the company had not used the post recovery tailwinds since 2020 to commit to returning $30bn to shareholders in buybacks and dividends by 2023. This clearly puts creditors at odds with shareholders pushing for an increase in alignment of executive compensation.

From a valuation standpoint, it is worth noting one important feature that differentiates stranded liabilities from stranded assets: Stranded liabilities are unlimited. This underscores the need for a deeper level of financial diligence when assessing different types of securities such as: longer duration bonds, asset based lending, credit default swaps, convertible bonds, as well as insurance linked securities or other derivative instruments.

Regulations drive how assets are managed rather than just how liabilities are mitigated:

A more sophisticated ESG regulatory lens is also needed when anticipating how valuations may change in areas where standardisation may already be further along, as with carbon accounting. Companies like Vale who rely heavily on exports will now see their European revenues impacted by a Carbon Border Adjustment Mechanism. As >90% of their emissions are scope 3, and how this is integrated will need to be assessed. Impending Biodiversity adjustment in ISSB disclosure requirements are also likely to make similar waves, not to mention the advent of carbon being institutionalised as a new asset class in itself.

The EU's Corporate Sustainability Due Diligence Directive (CSDDD"), once implemented will be yet another seismic catalyst in how prices reflect sustainability attributes. This has a lot more teeth than disclosure regulations. When European companies will be held legally responsible for the due diligence they undertake into suppliers like Vale. Their revenues will be directly influenced by how they stand up to scrutiny on the way they address human rights and biodiversity. This is also likely to result in inflationary shocks as result of fewer eligible suppliers potentially not being able to absorb the same demand at the same price points. There will be significant knock on effects on how debt instruments are valued and influence practices in various areas such as commodity trade finance. We expect significant opportunities in measurement, reporting and validation (MRV) solutions, particularly in how they related to Web3 applications.

For investment talent to remain competitive in various niche asset classes, a view on what are the likely ESG linked regulations and their implications is central to how they can maintain their edge. Commodity investors trading Iron Ore may want to rethink their informational edge when adjusting supply chain models. Private Equity investors will justify lower purchase prices and higher exits depending on how they account and resolve stranded liabilities. With companies like Vale representing 12% of the Bovespa index, cross asset or passive investors are not immune from knock on effects.

Executives across the investment industry face a similar challenge when structuring their investment teams and processes: How to allocate the right time and resources to conduct the depth of work required to deliver on their mandate.

As this case study illustrates, getting the required level of analysis right is highly dependent on the investment approach. The ESG linked financial risks are depend on the asset class, duration, liquidity, concentration, holding period and impact. This is both a challenge and an opportunity for alternative managers.

Business model transformation across the value chain is key.

As with today's incumbent asset managers, significant foresight and courage would have been needed for the Big Five studios to commit the transformative capital expenditure to roll out this innovative lens to all productions.

It took significant political capital for studios to invest enough capex to upgrade all cameras and upskill technicians.

It took a leap of faith to trust that movie theatres would adapt their projectors and for distributors to evolve their priorities.

It took entrepreneurial vision for new service providers to emerge, from makeup artists to costume and set designers and everything in between.

It took time for new talents to emerge who embodied colour as part of their craft from scriptwriters to actors and directors.

Even when narrowly defining a fund universe to select a manager from, what may seem like minor differences in investment styles will need to be carefully considered when adapting to a Coloured lens investing world. A highly diversified fund where analysts can cover 20-80 issuers each, struggle to even cope with the added burden of adding the three primary colours to their scalable black and white investment process.

The need to go beyond plugging in external ESG scores to adequately assess the complexity of colours is easier met by those with narrower coverage, which is likely to favour more concentrated strategies with longer holding periods. Diversification is no longer a "free lunch". Allocators that can afford to take a longer-term horizon when assessing risk adjusted returns, will be better placed to stomach the short-term volatility and reap the rewards from the accelerating dispersion that ESG is catalysing.

Asset and Wealth Management executives cannot underestimate the implications this has on their investment solutions, resource allocations, and business models. **This is a particularly disruptive opportunity for alternative investment boutiques.**

Every step of the investment value chain needs to adapt: from sourcing ideas, to managing portfolios, overseeing risks, adapting infrastructure to reporting and delivering the message to clients. **The traditional approach of incrementally dealing with one problem at a time does not work** when the industry is going through such a transformative change.

Various regulations and reporting obligations such as SFDR, the UN PRI's new reporting and assessment framework, company disclosures and market pricing dynamics, are being implemented at the same time. They are being met with broadening sophistication and standardisation that make it virtually impossible to survive with a business as usual approach. There has rarely been a greater premium rewarding those able to take and implement a long term vision. Conservative firms without sustainability at the core of their DNA are at risk not adapting fast enough once we are past the inflection point. **Plugging in an ESG data provider, hiring a head of sustainability, if they can still find one, and relabelling a few funds as ESG is no longer enough.**

The real hero of our story however is not the scientific genius of the esteemed Dr Herbet Kalmus, but rather his co-founder and estranged ex-wife, Natalie Kalmus. Her name appeared on more movie credits than anyone else in history, though history does not seem to have given her as much credit. As Head of Technicolor's Art department for 20 years, she described her role as "ringmaster to the rainbow" rendering her husband's creations fit for purpose.

Natalie Kalmus used a "Colour Chart" for psychological effects of colour. Colour can emanate particular "vibrations" that evoke a predicable range of emotional responses from viewers. As the on site representative "colour consultant" during the critical years of 1934-1949, her strong views on the balance of colour led her to repeatedly clash with studio personnel whom she felt were gratuitously overusing dramatic colours for theatrical effects. Going well beyond the remit of an external consultant overseeing the use of Technicolor cameras, she relentlessly battled with directors, cinematographers, actors costume and set designers on how to adapt each of their approaches to a more subtle use of colour.

She may have faced the ire of many producers such as David O Selznick who went so far as to angrily escalate his complaints to MGM's bosses during the filming of "Gone with the Wind" (1939).

Were it not for her persistence, proficiency and passion, it may not be known as the first colour film to win the Oscar for "best picture".

Natalie Kalmus had the rare talent of combining the nuanced grasp of colour of the great masters, with the technical engineering skills of film makers.

Leadership across the financial industry recognises the strategic importance of incorporating sustainability across their activities and investments. Messaging and rationale are increasingly communicated by an eloquent "head of sustainable investing" whilst the complexity of actual implementation is not always as clearly acknowledged.

Battle weary "heads of sustainability" across the industry may be feeling overstretched as a result of leadership having underestimated the actual required scope and depth of their involvement in every aspect of the business beyond reporting. The talent war may have intensified for anyone with a hint of ESG in their CV and despite ballooning teams, the output may not be as effective as long as these talents remain a cost centre relegated to a support function. Proliferating education and training content will continue to deepen, as accusations of "competence washing" highlight the gulf becomes more apparent between the "what" of ESG and its "how".

The key to success lies in identifying, enabling, and training those rare talents that combine a deeper understanding of sustainability, with the depth of investment technicity and how this differs across asset classes. Knowing how to turn that key is the testament to visionary leadership.

Enabling standardisation by categorising subjectivity

The anti-ESG backlash is a necessary step as we shift our perception of sustainable investing from an exponentially growing niche, to an industry-wide lens. It forces participants to delve into the level of complexity required to pragmatically recalibrate their strategy on an organisational level. The main challenge facing executives and regulators alike, revolves around tackling a central question: Where should subjectivity lie?

Which movie genre audiences most enjoy is clearly a subjective choice. Knowing how to identify the best producer, actor, and screenplay on the other hand, that is a matter of objective measure. Film critics, like fund selectors are entrusted by their audience to highlight films worth spending money on, or to express disappointment with a poor script, bad acting and an awful director. On the other hand, they immediately lose all credibility when complaining about the amount of violence in an action film or the lack of suspense in a romantic comedy

Sir David Attenborough has undoubtedly made a far greater positive contribution to society than Quentin Tarantino, but as with different investment styles, there is no central authority dictating which should be produced. That remains at the discretion of their audience. As long as the content is clearly labelled, the lower bound for what is legally acceptable can be shockingly low. The purpose of the production and what it claims to achieve provide a different baseline for what those legal lower bounds should be. Standards surrounding the factual accuracy of documentaries and news are very different to those surrounding violent fiction, but without the same colour baseline, neither would be possible.

The academy awards consistently changed rules, procedures and categories over the years having gone from 7 to 24 categories since 1930. They needed to remain adaptive to an evolving industry whilst maintaining the authority of the Oscars as the ultimate stamp of all that is good and worthy in the world of film. Unless one is to mention Will Smith's wife of course.

As classifications and preferences evolved so did accolades and standards. The Venice (1932) then Cannes International Film Festivals (1938) reflected their European artistic perspective. The Golden Globe Awards (1944) expanded recognition to include television, which the Emmy awards (1949) later focused on with its own set of adapted rules. The BAFTA awards (1947) then sought to reflect differing international preferences. As creativity exploded those that refused to come into the traditional fold were able to shine in alternative niches such as the Sundance Film Festival (1978).

What constitutes "greenwashing" can vary from factual misrepresentations made in bad faith, all the way to sanctimonious populism skewed by individual world views.

The only real constant is the endless scope for opinions to differ, and we certainly have our own which is beyond the scope of this paper. **The first issue we touch on here is that of questioning to whom belongs that subjectivity.**

Central authorities, such as regulators, strive to reflect a consensus view for what qualifies as being honest. Whilst necessary, this impossible task requires an exponential level of complexity that will never be adequate enough to address the specificity of different investment styles across each asset class. Going from how to represent black and white financial value to ensuring how multi-coloured values are reflected, is as challenging as trying to apply the same rigour of the Royal Institute of British Architects (RIBA) to how artists should be curated. In that light, regulators have done an impressive job in taking up this challenge, particularly considering the potential ramifications of unconstrained excesses which would be far more unacceptable than those witnessed in the art market

Whilst this enforces a much-needed baseline for systemic change in the global financial system, subjectivity may ultimately need to remain in the hands of asset owners and those entrusted to make allocations on their behalf. SFDR has been a powerful stick to propel ESG from the fringe into the mainstream, but investors cannot rely on it as a substitute for changing their investment story.

Relying on a central authority on how to read the script of a story is fundamentally different to changing the alphabet with which a story is told and enabling audiences to interpret those stories in a decentralised way.

Amidst the alphabet soup of regulatory initiatives, it is easy to lose sight of the tectonic shift the International Sustainability Standards Board (ISSB) is creating in changing the very alphabet of finance. Emanuel Faber's COP27 announcements of how they are aligning 20 other partner organisations will streamline how measurement and reporting can be standardised around a global baseline. The tedious process of incorporating climate related metrics has paved the road for a rapid expansion towards nature-based considerations which are to be announced imminently. Moving beyond minimum required standards, a wider acceptance of high-level concepts enables frameworks to evolve along clear segmentations that the investment value chain can organise around. **Clarifying disclosures to adequately contextualise what is greenwashing or not, widens the audience beyond what aspiration alone can do.**

Advances in AI, machine learning and blockchain allow us to measure so many more proxies of value. What they aim to measure, how reliably, over what time frame, on whose behalf and for what purpose, remain key questions for investors to grapple with. It is only possible to address these and move past binary generic questions like "is this an ESG fund?" by delineating where subjectivity lies, based on clearer definitions of high-level approaches.

Appropriately harnessing technology and new data sources allows us to better categorise what we are looking to measure. Rather than a quick fix by hijacking regulatory classifications like SFDR as though these are labels, we expect the result to be an increasingly decentralised offering amongst fund distribution platforms, wealth managers, fund of funds, consultants, or other fund allocators. Different portfolio solutions can be tailored to investor's ESG appetites, just like their preference for movie genres.

As an example, this can help recalibrate the foundations, that **Wealth Management organisational structures have been built around classifying and catering to individual client's needs, based on different shades of grey: conservative, balanced or growth. They have not been designed around asking them what their favourite colour is, let alone what movie genre they are into.** Systematising client and fund classifications around a similar framework enables a tailored client journey to be significantly more scalable. Short term incentive structures and budget constraints may lead many to take a minimally incremental approach to new regulatory requirements of capturing client sustainability preferences. This is a missed opportunity to retrofit their investment solution engines around a client journey that is fit for purpose when forging long term client relationships.

Our philosophy centres around our SITI™ framework that curates key areas of investor perspectives enabling firms across the investment value chain to adapt their strategy around a scalable sustainability lens.

Applying the right bottom-up framework for how subjectivity is applied in different asset classes and investment approaches will be critical in redesigning the business models further upstream in the investment value chain. **The opportunity is particularly exciting when designing new fund strategies, seeding managers, evaluating GP stakes, engaging with, and adding value to managers as well as how financial services M&A and multi manager boutiques evolve. Further downstream, established processes in fund selection, due diligence, portfolio construction and even strategic asset allocation models all face a generational challenge in how they are redesigned**. Getting this right levels, the playing field for new players just as it did for Disney, just as much as it reinforces the leadership of established player like MGM.

At the core of such a framework lies a granular understanding of dual materiality and how causality permeates different transmission mechanisms along the investment value chain.

Reengineering finance

To say that Technology has come a long way since the early days of Technicolor's earlier cameras is more than just an understatement. It masks the acceleration we have seen in recent years as the digital revolution takes us past streaming, CGI, VR and straight into the Regenerative AI and Web3.

What gets measured gets managed" is not a new climate change mantra. It is the basis that drives all economic activity. In 1950, Nielsen Media Research applied its Radio rating system to the growing Television market. That method became the primary source of audience measurement information in the US television industry and remains one of the main KPI's driving media executives to keep improving content and capturing audience's attention. Without this, it would be difficult to imagine how capital could have been redirected to the continuous innovation in how images are disseminated. As devices became smaller and cheaper proliferating from theatres to every home, room, pocket, and wrist, we witnessed an unparalleled decentralisation of news, ideas, and opinions.

Netflix masterfully harnessed technology measuring audience engagement after it transitioned to a streaming service in 2007 as their algorithms allow each viewer to tailor their personal experience

We expect technology to play a similar role in equipping the financial industry with a sustainability lens. This should trigger a radical shift in various business models and investment processes along the investment supply chain. The "adapt or die" adage will ring far truer as the economic cycle turns and amplifies the consequences on those less resilient and unprepared.

In the case of financials first investors, this will continue to be evolutionary. For outcomes first investors this implies the need for an approach that is nothing short of revolutionary.

Data sets and analytical tools are broadening out beyond the incumbents that gained market dominance by catering to financial first concerns. AI and blockchain technology have enabled many new measurement approaches that can go beyond the self-reported data that remains susceptible to greenwashing.

From satellite imagery to scrapping thousands of news articles and social media, there are more opportunities for companies to get caught out under the intensifying scrutiny of investors using these "non-financial metrics".

Being able to trace the evolution of these data sets over time unlocks the scope of scrutiny beyond how we align our values. It provides the right context to assess how effectively value is being created. This is essential to enable frameworks and regulations supporting transition pathways and the move toward real progress, rather than arbitrary compliance.

We expect the explosion of ESG solutions to broaden globally, expand across asset classes, then eventually disappear from our lexicon as this just becomes the minimal accepted standard for how capital should be invested. The Motion Picture Association (1945) set minimum standards for film classifications and was emulated internationally according to varying cultural norms. Despite being an independent non enforced certification, this enabled film distributors to adapt their processes and criteria for selection.

Regenerating finance:

The drive to shape outcomes beyond ESG integration, has the potential to flip parts of the investment landscape upside down. Forward thinking, creative managers have a unique opportunity to lead the pack by designing solutions that incorporate impact from the outset.

The real change however comes from how asset owners adapt the foundations upon which they build trust. Rather than dogmatic adherence to easy proxies of safety such as minimum track records, critical mass and brand recognition, the right allocations require more hard work in fundamental manager selection by re-prioritising competence and strategy.

Rethinking asset classes as enablers:

Even in fully sustainable mandates, we remain accustomed to thinking of fund allocations in a black and white context where the asset class's expected risk/return profile remains the primary objective with any impact as a desirable outcome to then optimise. As measurement improves, we expect data such as "emission reductions" to gradually become one of the primary value propositions of some funds, rather than just the risk adjusted returns expected from that asset class with additional ESG transparency as a by-product. The investment strategy becomes just another building block that is used to achieve that outcome, rather than the end goal itself that passes the selection hurdles.

Innovative tools now allow us to refocus fund due diligence towards the credibility and effectiveness of an investment approach by combining the right data sets with the right frameworks through which to assess them.

This shifts the spotlight onto the transmission mechanisms available within each asset class. Fund allocators, particularly those subject to the new PRI reporting Framework assessment, will increasingly focus their selection criteria on how effectively managers are utilising them, rather than merely complying with disclosures, and optimising for optics.

Clearly this will be more efficiently done by newer and more innovative funds, rather than incumbents that may fear rocking the boat and risking their existing franchise. **This presents a significant opportunity to amplify financial returns for those willing to catalyse this shift through seeding arrangements and GP stakes. Family offices are in a unique position to go further than most, given their nimble decision-making, long-term horizon and more nuanced understanding of what the owner's favourite colour and movie genre is.**

The slower but more meaningful shift, however, is unlocked once asset owners engage directly with those incumbent fund managers on how they deploy the critical mass of assets already allocated. Having the right framework provides the basis for how they can best influence established managers to adapt their investment process according to their asset class, investment strategy and edge. As a result, a far greater emphasis is placed on the relationship with alternative investment funds given their disproportionate scope for shaping outcomes. This is particularly pertinent in how they integrate systemic risks related to climate, biodiversity and human rights. **Allocators with significant new capital to deploy such as in the Middle East and Asia have timely opportunity to bring their perspective to how the rest of this story unfolds.**

Conclusion

The script is still being written for how the investment industry evolves with many plot twists and narratives yet to unfold. One thing is sure however, is that the storyline is clearly on set on systems change with sustainability becoming a lens applied to all activities.

Financial returns have always been predicated on exposing capital to "what is likely to happen". Adding an ESG lens can only enhance this and as with the shift from black and white film to colour, this will just become standard practice for all investment solutions. Allocating capital to influence "what ought to happen" is nothing short of revolutionary with significant disruption for all business models and investment solutions. Success in both is predicated on the right integration of data and the frameworks and approaches they are used by all players across the investment value chain.

Regulations, innovation, and incentive structures are coalescing towards a standardisation of dual materiality. This is becoming an increasingly meaningful influence in the price discovery mechanism and will narrow the gap between "what ought to happen" and "what is likely to happen". Whilst this is great news for how we hope to meet real global challenges, albeit too slowly, it does not bode well for investment houses that do not adapt their corporate strategy fast enough.

As we have illustrated through Vale, the level of granularity required to retrofit investment processes goes well beyond the incremental "bolt on" approaches and requires a level of nuance that makes it challenging for existing investment talents to contend with when trying to maintain the same level of diversification they enjoyed.

We face a substantially wider scope for where subjectivity lies, how far to go in relying on it and deciding within whose remit it lies. This added level of complexity in our system underscores the need for higher level frameworks that can align asset owners and asset managers around the same lens. **We are excited about the opportunity this represents for innovative fund solutions, enabling tools and the frameworks that create them.** We have seen this movie before, but it certainly was not with the same production and is very likely to have different actors becoming stars.

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About us

Kalmus Capital is an independent sustainable investment advisory firm working with asset owners, asset managers, non profit organisations and technology innovations. We focus on innovating and scaling investment solutions and MRV tools adapted to ESG and impact investing. Our edge lies in scrutinising the transmission mechanisms across the investment value chain to identify the addressable pivot points that amplify impact. We partner with a select group of subject experts across the ESG spectrum. Kalmus Capital is a registered investment advisor with the ARIF based in Switzerland.

About the author

Joseph Naayem, CFA is the founder and Managing Partner of Kalmus Capital. He has spent most of his career at the intersection of sustainable finance and alternative investments. In 2020 in partnership with Contrast Capital, he worked on redesigning and rewriting the new mandatory PRI reporting and assessment framework. Joseph previously ran UBS Wealth Management's Hedge Fund advisory business in Europe, and has spent most of his career as a portfolio manager and fund analyst in various European Fund of Funds. In 2013 he co-founded Prius Partners, one of the first SaaS solutions to map ESG data to fund holdings and was an early stage investor in various early stage impact innovations. He also loves movies and may be prone to occasionally overstretching some analogies.

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