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PATIENT CAPITAL: THE KEY TO REBALANCING FINANCIAL MARKETS?

Abdeldjellil Bouzidi, Managing Partner, Emena Advisory

Webinar

Monday, 18 January 2021, 10:00 GMT

A WORD FROM TODAY'S CHAIRMAN

FS Club

Professor Michael Mainelli

Executive Chairman

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TODAY'S AGENDA

FS Club

- 10:00 – 10:05 Chairman's Introduction
- 10:05 – 10:30 Keynote Address - Djellil Bouzidi
- 10:30 – 10:45 Questions & Answers

TODAY'S SPEAKER

Abdeldjellil Bouzidi

Managing Partner

Emena Advisory

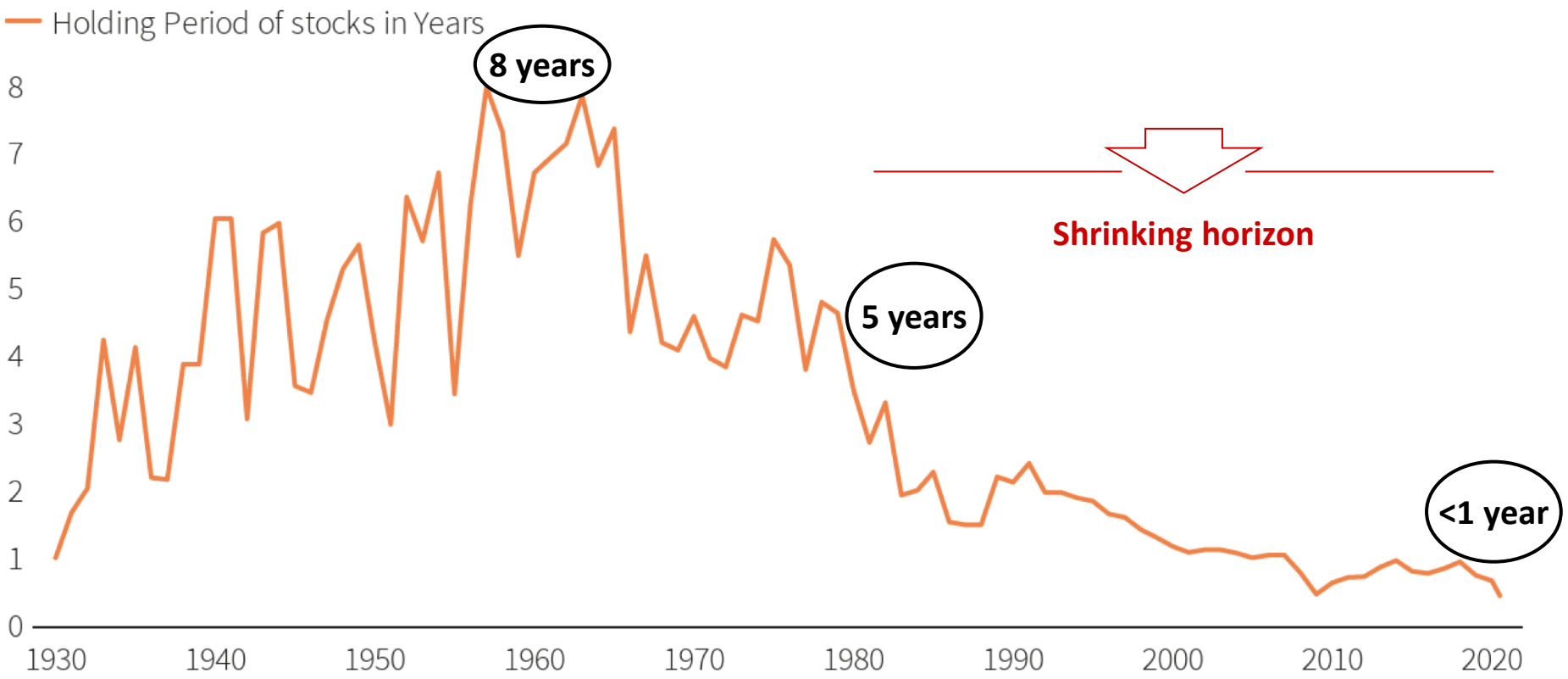
Patient capital: the key to rebalancing capital markets

Djellil Bouzidi

What is the average holding period of stocks?

1. *> 8 years?*
2. *5 to 8 years?*
3. *3 to 5 years?*
4. *1 to 3 years?*
5. *Less than 1 year?*

Capital markets time perspective

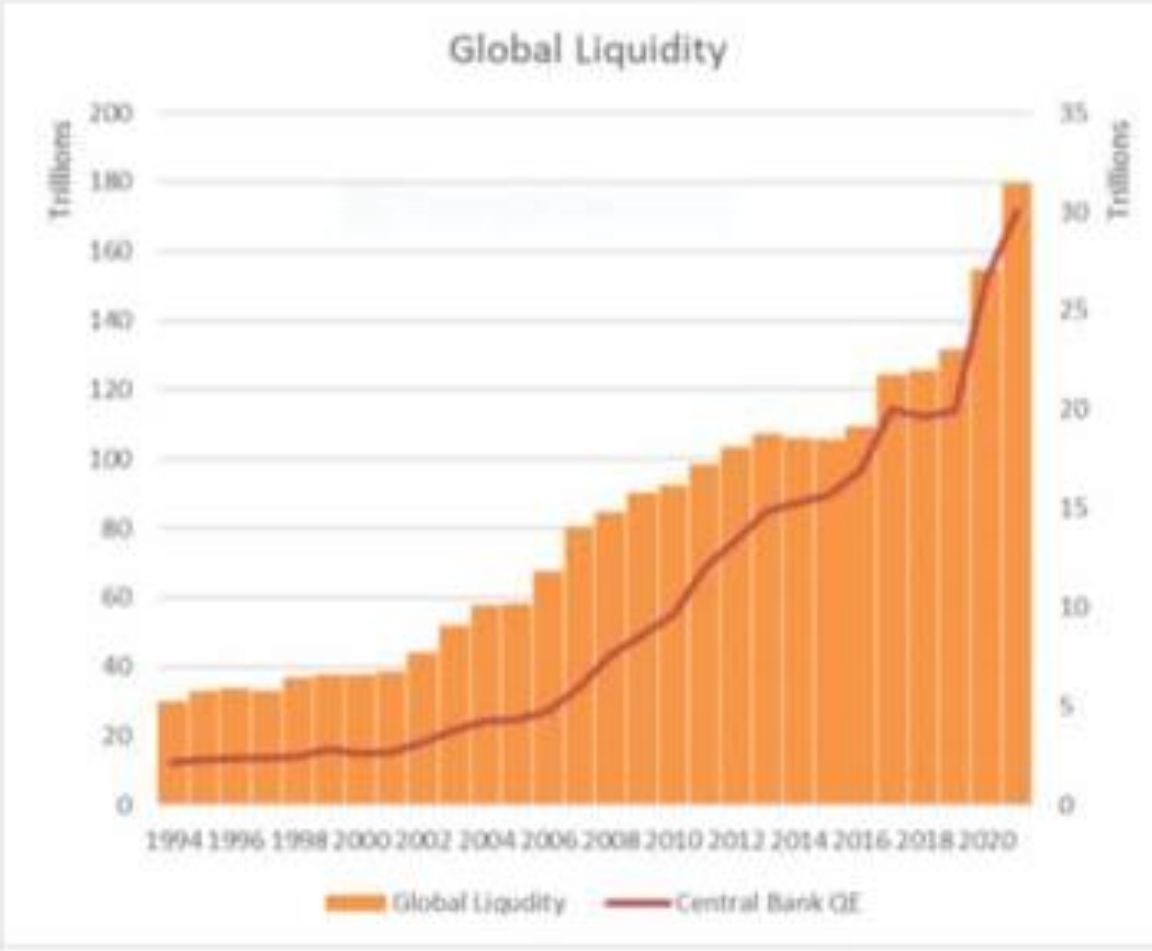


Note: Holding periods measured by value of stocks divided by turnover
Source: NYSE, Refinitiv

A growing challenge: too much liquidity…

A world awash in money

The cash paradox illustrates the preference of the 'present' versus 'future generations'. The world has never been so awash with money, and yet we are still lacking green investments.



Source: CrossBorder Capital

…and huge investment needs in low-carbon energy transition

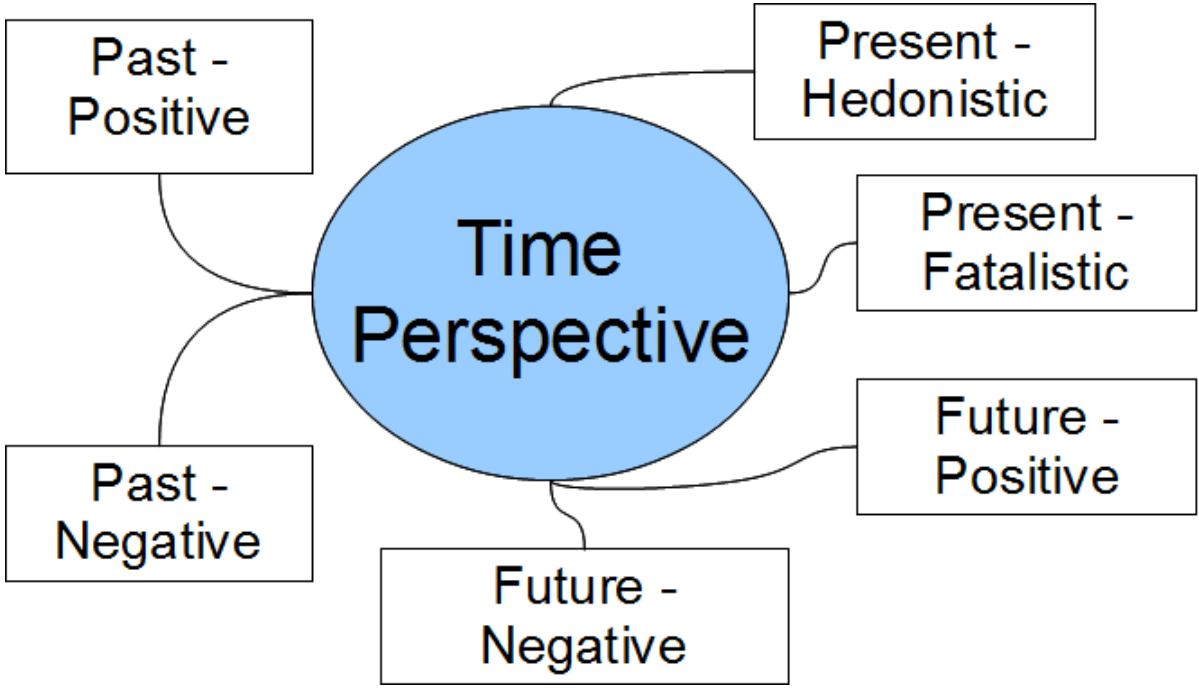
Huge needs to fight climate change

- The volume of **investments needed** (additional annual average energy-related investments) to limit global warming to 1.5°C (over the period 2016 to 2050, compared to the baseline): **150 billion to $1,700 billion**
- **Total investments in low-carbon energy** also vary greatly, from **$0.8 trillion to $2.9 trillio**n
- Global investments needed in **sustainable infrastructure** for the period 2015–30 range from less than **$20 trillion to close to $100 trillion**

Source: BIS (2020), "The Green Swan. Central banking and financial stability in the age of climate change".

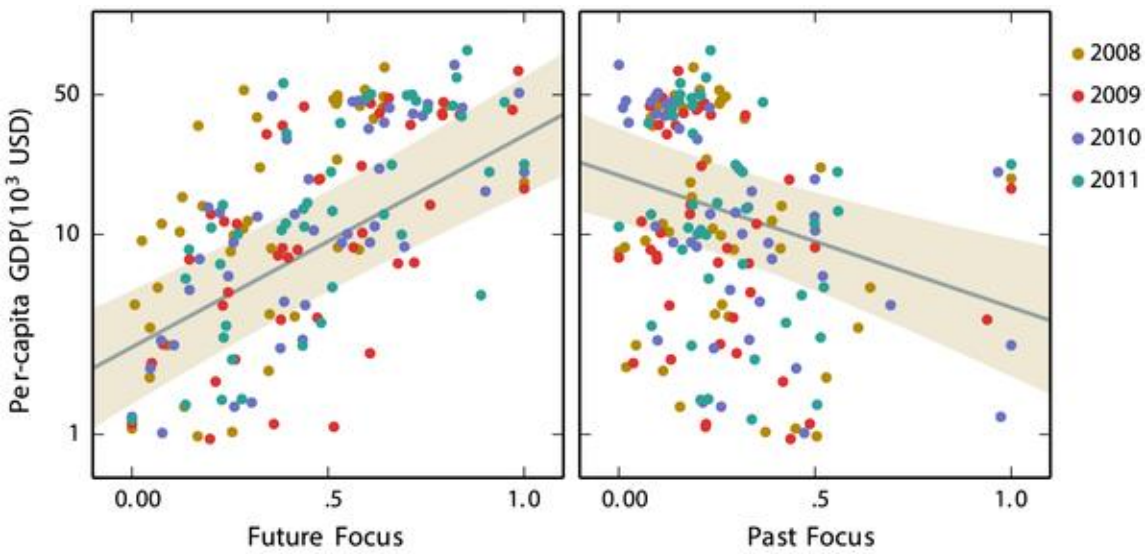
Impatient capital is driven by time perspective

"I'm interested in buying some investment bonds that will pay off in about fifteen years."



Time perspective of nations

Future focus vs. Past focus



A study showed that countries with a "collective long-term vision" have a higher per-capita GDP.

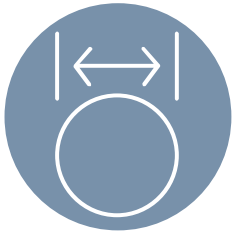
Future focus measures the extent to which a nation was focused on the future, relative to the present.

Unlike future focus, findings suggest that past focus may have a negative relationship with economic activity.

Source: Noguchi T, Stewart N, Olivola CY, Moat HS, Preis T (2014) Characterizing the Time-Perspective of Nations with Search Engine Query Data. PLoS ONE 9(4): e95209. https://doi.org/10.1371/journal.pone.0095209

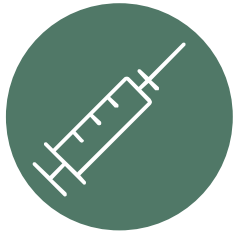
Recommendations to increase patient capital

Asset class innovation



- *Sustainability-Linked Bonds/Loans*
- *Environmental Impact Bonds (pay-for-success)*

Prudential innovation



- *Brown penalizing vs. Green supporting factor*
- *Green collateral*

Accounting norms

- *Green discounting*
- *Public good criteria*

Legal / Institutional

- *Voting rights repo for all shareholders*
- *Ex-ante double voting rights*
- *Green sovereign funds*

Focus: Sovereign Sustainability-Linked Bonds (Policy Performance Bonds)

ASSET CLASS | INNOVATION

Some history…

We first proposed the use of several such bonds for environmental, social, and governance (ESG) purposes as part of the Long Finance initiative in journal articles from 2009, such as "Index-linked Carbon Bonds: Gilty Green Government", and other publications, and in some detail in 2017 with the publication of the book, "L'Innovation Financière Au Service Du Climat: Les Obligations à Impact Environnemental". In addition to these publications, the paper "Environmental Policy Performance Bonds" published in 2015

A series of ESG bond 'flavours' seem to be emerging, in increasing order of sophistication:

1. *green bonds that claim proceeds will be applied to green projects;*
2. *sustainability or ESG bonds that claim proceeds will be used for wider ESG goals;*
3. *sustainability or ESG bonds where the issuer will report directly on the target(s), e.g. Alphabet/Google's US$5.75 billion 2020 bond issue will report on progress of project investments in energy efficiency, renewable energy, green buildings, clean transport, circular economy & design, affordable housing, racial equality, and support for small businesses in the wake of Covid-19;*
4. *policy performance bonds where interest rates are linked to achievement.*

Sovereign Sustainability-Linked Bonds

Policy performance bonds are different from green or ESG bonds. They are 'linked', i.e. the issuer is putting its money where its mouth is on guaranteeing outcomes. Unlike green bonds, policy performance bonds are relatively agnostic about how the funds raised are applied, but care enormously about achieving targeted outcomes. These instruments are less expensive to administer and harder-hitting on underperformance than un-hypothecated green bonds. Terminology is still evolving with policy performance bonds also known as 'positive incentive' or 'sustainability-linked' loans.

A major step was taken recently by the European Central Bank (ECB) who decided to accept such instruments as collateral for credit operations even if they are quite new and issued by few private players. Commenting on the ECB decision, Christine Lagarde declared: "Climate change is everybody's responsibility. As I have said before, I want to explore every avenue available in order to combat climate change, and this is another step in the right direction".

Focus: green discounting for the future

ACCOUNTING NORMS | INNOVATION

The Power of Discounting

Discounting, and more generally accounting, governs the day-to-day activity of institutional investors and listed companies. Its influence is much more significant than taxes, and yet it attracts much less attention.

If you invest in a project, a company or a financial instrument, you have to discount the future cash flows to obtain their 'value' today and make your decision. The logic of discounting is powerful and combines a mix of risk, reward and time preference. Discounting is king. But is it taking into account the interest of future generations?

The green climate premium

To take into account the climate damage and carbon footprint of each project, I suggest adding a 2% climate premium for the coal project and a 0% premium for the renewables project. This would make the coal project lose money with a net present value of minus $14.3 million. You can see the huge impact on the value of future cash flows caused by this green climate premium.

The climate premium would depend on the carbon and environmental footprint of the project or company. It is the difference between the true value of an investment and its climate risk-free value.

How could one compute such a climate premium?

Ideally, climate premiums should be market-based. However, such markets don't exist yet. It is one of the reasons that has led me, together with Professor Michael Mainelli, to argue in favour of the creation of a new asset class: environmental policy performance bonds - let's call them carbon dioxide (CO2) bonds. The coupons of CO2 bonds would be linked to CO2 reduction targets. The more a government reduces CO2 emissions, the less interest the government pays.

Appendix

Framework/heuristic to determine level of patience

1. Initial Intended Investment Term?	2. Voice Motivated by Short-Term Performance?	3. Likelihood of Exit Motivated by Poor Short-Term Performance?	Patience
Short			Very Low
Long	Yes		Low
	No	High	Low
		Medium	Medium
		Unlikely	High
		Almost Never	Very High

Source: Deeg and Hardie (2016), "What is patient capital and who supplies it?", Socio-Economic Review

QUESTIONS AND ANSWERS

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- Tuesday 19 Jan (09:00) Psychology Of Leading A Hybrid Workforce
- Wednesday 20 Jan (09:00) Financial Centres Of The World 2021: Focus On Dubai
- Thursday 21 Jan (10:00) An Update On EU Financial Services Legislation & Associated Initiatives
- Friday 22 Jan (12:00) Owning Your Place In A 21st Century Economy
- Wednesday 27 Jan (14:00) What EU Insurance Mutuals & Cooperatives Have Been Doing Well During Covid-19

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