RATHBONES

FROM RISK TO RESILIENCE

How long-term investors can protect value and promote resilience in an interconnected world

CONTENTS

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FOREWORD

Achieving a sustainable economy is more important than ever – not as a matter of ideology or political agenda, but because it's a physical reality. Issues such as biodiversity loss, resource constraints, climate change, pollution, health and wellbeing, and social inequality all have tangible impacts. They pose significant risks to citizens, investors and the broader economy, both now and in the long term.

No single actor in the economy can solve these challenges alone. They require large-scale, urgent collaboration between policymakers, asset managers, asset owners such as pension funds, and companies. Systemic issues demand a systemic response.

Asset managers and asset owners must work together to incorporate social and environmental systemic risks into the investment process. This approach not only helps protect client assets over the long term but also creates opportunities as the economy transitions to a more sustainable model.

Explore more responsible investment themes

This article is the fourth in our series about investing responsibly. The first is *Investing for good*, which explores how investors can make a positive impact on society and the environment through their investments. The second is *Behind ESG ratings*, which seeks to make sense of environmental, social and governance ratings within the investment process. The third is *The divestment debate*, which explores how companies and investors can balance financial goals, ethical values and climate responsibility.

Please ask your investment manager for a copy or visit www.rathbones.com/knowledge-and-insight/responsible-investment

WHAT IS SYSTEMIC RISK?

Systemic risk refers to the breakdown of an entire system rather than just the failure of individual parts. In finance, it describes cascading failures across the system – linked events that result in severe economic downturn (CFA Institute, 2022). The 2008 Global Financial Crisis is a clear example. More recent events include the Covid-19 pandemic and Russia's invasion of Ukraine, which led to global inflation and a widespread cost-of-living crisis.

Systemic environmental, social and governance (ESG) risks arise when these factors disrupt entire sectors, regions or the global economy. Examples include climate change, biodiversity loss, social inequality and antimicrobial resistance.

Investors often think about ESG risks at the company level – for instance, examining a firm's health and safety practices, water use or exposure to modern slavery. These are idiosyncratic risks, meaning they are specific to individual assets. As we noted in our 2024 article *Behind ESG ratings*, understanding these company-level risks is an important part of investment management.

A good example is Boohoo, the UK fast fashion retailer. In 2020, allegations of labour abuses in its domestic supply chain led to an immediate drop in its share price.

How systemic risks differ

Systemic ESG risks go far beyond individual companies. For example, biodiversity loss can increase the spread of infectious diseases through ecosystem disruption and closer contact between humans and wildlife. At the same time, biodiversity is a vital input for the development of new medicines. The loss of biodiversity creates a systemic risk by both raising disease risk and undermining pharmaceutical innovation and development.

A single pharmaceutical company can assess and manage its own exposure by mapping its dependence and impact on biodiversity, creating protection policies and supporting restoration efforts. This approach can reduce the risk of business interruption, reputational damage or litigation. However, no company can address biodiversity loss alone. It cannot control the damage caused by activities like mining, infrastructure development or land use change driven by agriculture.

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The rising urgency

According to the World Economic Forum (WEF), systemic ESG risks are intensifying. The WEF *Global Risks Report* draws on insights from academia, business, government and civil society to warn that these risks are growing more frequent and more severe. The 2025 edition notes that "the ensuing risks are becoming more complex, and urgent, and accentuating a paradigm shift in the world order characterized by greater instability, polarizing narratives, eroding trust and insecurity" (World Economic Forum, 2025).

Despite this evidence, current ESG risk management often overlooks the connection between financial performance and the long-term stability of environmental and social systems (Impact Management Platform, 2023). This disconnect is a critical issue for investors to address.

WHY DOES IT MATTER TO INVESTORS?

By their nature, systemic risks cannot be diversified away. While investors can reduce exposure to company-specific (idiosyncratic) risks by avoiding poorly managed assets or building a diversified portfolio, they cannot escape risks that affect the entire system. For long-term investors, portfolio performance is largely driven by the health of the overall economy.

Institutional investors – including pension funds, mutual funds and endowments – often hold portfolios that are so broad and diversified that they own a slice of the entire economy. This concept is known as universal ownership (UN PRI, 2017). It also extends to many retail investors, who hold pensions or investments through these institutions. Passive investors, in particular, may be considered universal owners, as they invest in funds that aim to match the returns of a specific market or index.

For these investors, financial returns depend on the continued wellbeing of the economic system as a whole. That means contributing to sustainable outcomes isn't just a moral imperative – it's a financial one.

Why real-world outcomes matter
System-wide risks can only be mitigated by creating real-world change (Quigley, 2020). This approach shifts the focus from managing ESG factors for performance reasons to using capital as a lever to influence the system itself.

For example, not providing primary capital to expand fossil fuel extraction, or vote against directors who fail to meet climate commitments. Addressing systemic risks requires aligned, collective action on a large scale.

Company executives often focus on short-term financial performance, which can lead to decisions that ignore systemic impacts. For instance, some firms treat greenhouse gas emissions as externalities – costs that are passed on to society rather than accounted for internally.

As Lukomnik & Hawley (2016) explain, this disconnect creates a misalignment. Investors are concerned not only with the performance of individual holdings but also with the long-term consequences of those emissions for the wider economy. This divergence makes it harder for investors to manage systemic risks through traditional engagement.

When it comes to climate risk, investors cannot simply stock-pick their way out of trouble.

Climate risk and the long view
When it comes to climate risk, investors cannot simply stock-pick their way out of trouble. Over the medium to long term, losses from climate impacts will affect the entire economy, including portfolios that seem diversified today (Quigley, 2019). For long-term investors, good ESG performance at the stock level is no longer enough. What's also needed is a stable, resilient global economy. A healthy economy depends on a healthy society and a stable environment.

SYSTEMS INVESTING: A NEW APPROACH

Managing systemic risk requires enabling real-world change by addressing the interconnected nature of complex systems. This approach is known as systems investing – an emerging philosophy that sits at the intersection of impact investing, philanthropy and sustainable finance (Tews, Jay, & Anderson, 2025).

Systems investing leverages a different way of thinking. It's fundamentally collaborative. It requires the active participation of all stakeholders in a system – asset managers, asset owners, companies, non-governmental organisations (NGOs) and others – to shift how issues are tackled. Rather than targeting isolated problems, systems investing focuses on the interconnected factors that underpin a challenge and the relationships between different factors.

From point solutions to systemic thinking

Traditionally, solutions to sustainability challenges have taken a narrow, issue-specific approach. In the world of software, these are known as *point solutions*. One example is replacing petrol and diesel cars with electric vehicles. While this transition lowers noise pollution and improves local air quality, it doesn't fundamentally change the underlying system of private ownership, nor does it enable the scale and pace of emissions reduction required to have a meaningful impact on global emissions.

A systems-based solution would go further by promoting the use of public transport or rethinking urban design to prioritise walking and cycling. This kind of change is more complex but also more powerful because it addresses the structure of the system itself.

Systems thinking is a tool for understanding complexity. Inherent in systems thinking is the awareness of the interconnected nature of systems. It recognises that change in one part of a system can create ripple effects elsewhere. By identifying key leverage points – places where relatively small interventions can generate large, cascading impacts – systems thinking helps amplify positive outcomes.

Stewardship through a systems lens

Adopting a systems approach also means rethinking stewardship. In *Active Ownership 2.0*, the PRI outlines three key principles for doing this effectively (Peres da Costa & Chandler, 2019):

- **Focus on real-world outcomes.** Traditional stewardship has often centred on activities or disclosures that aid decision making but don't necessarily change outcomes. A systems approach prioritises impact.
- **Align around common goals.** Investors should focus on shared challenges such as climate change and human rights, rather than narrow, stock-specific risks.
- **Collaborate to avoid the free rider problem.** When investors act together, they share the cost of stewardship and the benefits. This collaboration is especially important because systemic risks, by definition, cannot be tackled alone.

Systems stewardship also includes active engagement with public policy. Because systemic risks are market-wide, creating change often means helping to shape the rules of the system itself.

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THE ROLE OF ASSET MANAGERS AND ASSET OWNERS

Building resilient portfolios
Asset managers have a responsibility to help asset owners understand and manage systemic risks. This support should be a core part of the service they provide. By clearly communicating the materiality of these risks, asset managers can help clients create investment mandates that are both climate-aware and socially responsible.[1]

Take climate risk, for example. Asset managers could provide scenario-based insights on portfolio value-at-risk from physical and transition-related climate impacts.[2] This enables asset owners to make informed decisions and assess different ways to reduce exposure.

Working with fiduciary duty
Asset managers are bound by fiduciary duty – the obligation to act in the best interests of their clients. As we explored in our 2024 article The divestment debate, this obligation includes the consideration of risks and real-world impacts.

There is room for innovation here. Asset managers can explore new ways to address systemic risks while remaining within the bounds of fiduciary responsibility. At the heart of this process is a recognition that people shape systems – and that deliberate action can help to reshape them.

As Climate KIC, Europe's largest climate innovation initiative, puts it: asset managers should "critically reflect upon the role they play in shaping the future, and make a deliberate choice of action over complacency and responsibility over deference". (Hofstetter, 2020)

The need for collaboration
Tackling systemic risk requires shared solutions. These risks are too large, too interconnected and too urgent for any one institution to handle alone. That means new ways of working by collaborating not just with other asset managers, but also with philanthropists and public institutions.

[1] A material risk is one that could have a significant impact.

[2] Value at risk estimates the potential loss that could be expected under a pessimistic scenario over a specified period.

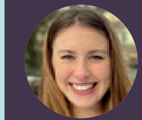
Asset owners have a vital role to play. They can use their capital to influence how systems evolve – and they don't have to do this alone. By asking the right questions and setting clear expectations, they can hold managers accountable for how systemic risks are managed.

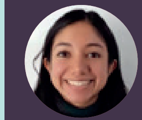
Why investing in resilience makes sense
Asset owners can also build resilience directly into their portfolios by investing in solutions that address these risks at source. This includes climate adaptation, energy access, infrastructure and food security.

Investing in resilience doesn't just support system-wide change – it can enhance portfolio stability too. For example, improving climate adaption in vulnerable regions may reduce supply chain disruptions, boost productivity and lower long-term costs. The result? Higher credit ratings, better access to capital and improved profitability (Al-Mashat, Neo, Puri, & Phillips, 2024).

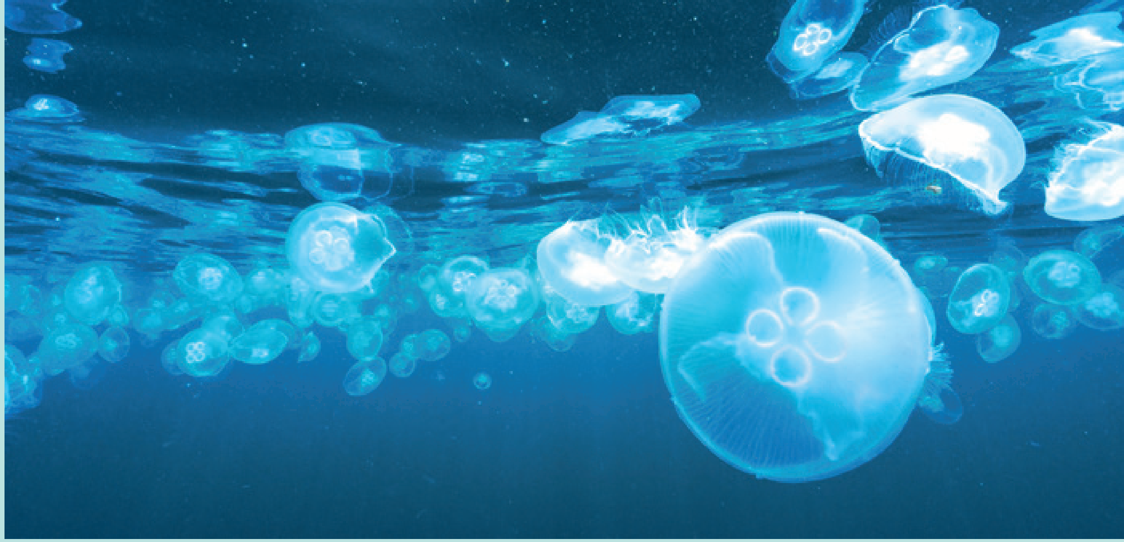
The World Economic Forum has estimated the market opportunity in climate adaptation at $2 trillion by 2026 (Shum, Jeong, & Chen, 2022). This opportunity reflects both a challenge and a choice: investors can help shape a more resilient economy and benefit from it.

FACING RISK, SHAPING RESPONSE





Elizabeth Clark (top) and Trisha Mani lead the research programme for the Investment Leaders Group, a global network of pension funds, insurers and asset managers with over US$9 trillion under management and advice, at the University of Cambridge Institute for Sustainability Leadership (CISL). CISL is an impact-led institute within the University of Cambridge that activates leadership globally to transform economies for people, nature, and climate.



The climate and biodiversity crises are no longer distant threats but pressing realities that demand immediate attention. In 2024, Spain saw one of the deadliest natural disasters in its history, as rains in Valencia killed more than 200 people, inundated homes, and damaged businesses. Just weeks earlier, Hurricane Milton left a trail of devastation across the Atlantic. With global average temperature exceeding 1.5°C above pre-industrial levels for the first time in 2024, officially making it the hottest year on record, extreme weather is now inevitable.[3]

With an increasingly interconnected global economy, extreme weather events in one part of the world can impact businesses, economies and livelihoods of people in another. These are systemic risks: compounding, non-linear disruptions that challenge the foundations of modern portfolio theory. They are not distant risks to be priced in over decades, but are unfolding now, threatening both the short and long-term performance of investment portfolios.

The systemic nature of climate change therefore requires a systemic response – one in which both asset owners and asset managers have the chance to play a critical, meaningful role.

Recognise why progress hasn't happened to date. Traditional investment approaches and tools like historical benchmarks, volatility measures, and narrow negative ESG screening are not fit for purpose. Systemic risk cannot be diversified away; it must be addressed. That requires reshaping financial incentives, demanding structural reform, and investing in solutions that build resilience at scale, particularly in vulnerable geographies.

Ensure you are aligned on not just the threat but the opportunity. The challenge isn't whether this transition will happen – it's whether it will happen fast enough. In the UK's seventh carbon budget, released in February, the net cost of the transition for the UK is 73% lower than previously thought under its sixth carbon budget advice, published in 2020.[4] The next generation of market leaders will be defined by their strength in clean technologies, AI-optimised efficiency, sustainable food systems and circular business models. The question for investors, therefore, is how do we keep delivering in the short term while positioning for long-term success in a fast-changing world?

Change the mindset around your role. Asset owners are not passive recipients of risk, and in a world increasingly underpinned by systemic risks, it is imperative that they take an active role in informed decision-making. At the same time, as asset managers, it is increasingly important to not only assess the financial materiality of systemic risks but also develop the tools and frameworks to address them. For example, in the case of physical climate risks, asset managers must incorporate up-to-date climate scenario analyses into both economic and growth forecasts so that asset owners can set climate-aware investment mandates. Establishing clear climate and nature objectives from the start empowers investment managers to integrate climate risks and opportunities more effectively throughout the portfolio and investment process.

Change the narrative around your approach. Traditionally, integrating climate considerations into client objectives has been framed predominantly through either an impact-driven narrative, focusing on the ethical and environmental consequences of climate risks. However, in the context of systemic risks, the narrative is no longer one based on impact or ethics, but on risk and return – outlining the financial materiality of inaction.

[3] Copernicus, "2024 is the first year to exceed 1.5°C above pre-industrial level".

[4] Climate Change Committee, "the Seventh Carbon Budget".

Recognise the interconnected nature of the global economy. Systemic risks are often embedded in a complex web of interconnected linkages, meaning, events in one part of the world have a financial and material impact on economies in another. As a result, they cannot simply be hedged against or diversified away. For example, certain regions in India are approaching temperature thresholds making heat-exposed outdoor work, which employs nearly 75% of the country's labour force, deeply dangerous to human health.[5]

As the rise in temperature accelerates, the ripple effects will significantly disrupt economic activities across different sectors in India, leading to cascading effects across the global economic system. By investing in strengthening local systems in vulnerable regions, investors can mitigate the cascading effects of systemic risks and improve portfolio resilience in the long term.

Lean into systems stewardship. Delivering a robust climate stewardship strategy that ultimately delivers value for its members is essential. However, as Dr. Tom Gosling said in the Rathbones article *Investing for good*, the chain of causality from investor action to company action through to system change is a rusty one with many fragile links. By taking an active role in ownership and portfolio engagement, investors can apply a systems lens to investment decision-making that will not only future-proof

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portfolios but also help identify new opportunities and markets for investment.

Investors play a key role in the financial ecosystem and have the power to facilitate change when their efforts are coordinated and targeted. However, they face real constraints: markets that fail to price externalities, that favour short-term performance over long-term value creation, and subsidies that favour damaging incumbents.

Addressing systemic risk, therefore, requires active engagement in changing today's economic reality. More proactive policy and other measures must adapt to the changing environment for the markets to deliver change at the pace required. By advocating for clear incentives, a unified strategy and increased collaboration across the financial system, investors can spearhead efforts to address systemic risks.

[5] McKinsey, "Climate risk and response: Physical hazards and socioeconomic impacts."

RETHINKING SYSTEMS

Financial capital is a powerful driver of change. Asset owners hold a unique position in the system – they can use their investments not only to seek returns but to influence how markets and economies operate. By taking a strategic, informed and collaborative approach, they can help shape a financial system that supports a healthier society and environment.

Asset owners can start by developing a deeper understanding of how environmental and social risks interact – and how these systemic risks affect long-term outcomes. This understanding should feed into investment mandates that reflect wider priorities, from biodiversity to social resilience. They can also direct capital towards solutions that help build resilience to systems. Asset managers can also widen their understanding of risk. Rather than focusing only on risk mitigation at the company level, asset managers can also integrate systemic risk into their investment frameworks and direct capital into solutions that strengthen the overall system.

Making resilience a strategic goal
Investing in resilience means going beyond exclusion or screening strategies. It involves actively allocating capital to initiatives that help reduce the impact of systemic risks, such as climate adaptation, social infrastructure or nature-positive development.

By investing in resilience, asset owners are not only supporting long-term sustainability goals – they are also helping to protect the value of their own portfolios.

Working with asset managers
This approach to resilience and risk doesn't happen in isolation. Asset owners should expect transparency from their investment managers about how systemic risks are being addressed across portfolios. In turn, asset managers should ensure they are clearly communicating the risks and explaining how those risks are being managed in practice.

Because of their scale, asset managers also have the ability to drive industry-wide collaboration by coordinating stewardship efforts, engaging with policy and supporting systemic change at pace.

People shape systems
While systems often feel self-sustaining or impersonal, they are ultimately shaped and run by people. Rules can be changed. Priorities can be reset. No single person, firm or fund can solve systemic risk alone but everyone can contribute to a shared solution. This belief – that individuals and institutions have agency – is central to a systems-based approach. When decision-makers act collectively, the potential for lasting, positive change increases dramatically. In the tide of human affairs, strength lies in numbers.

Find out more

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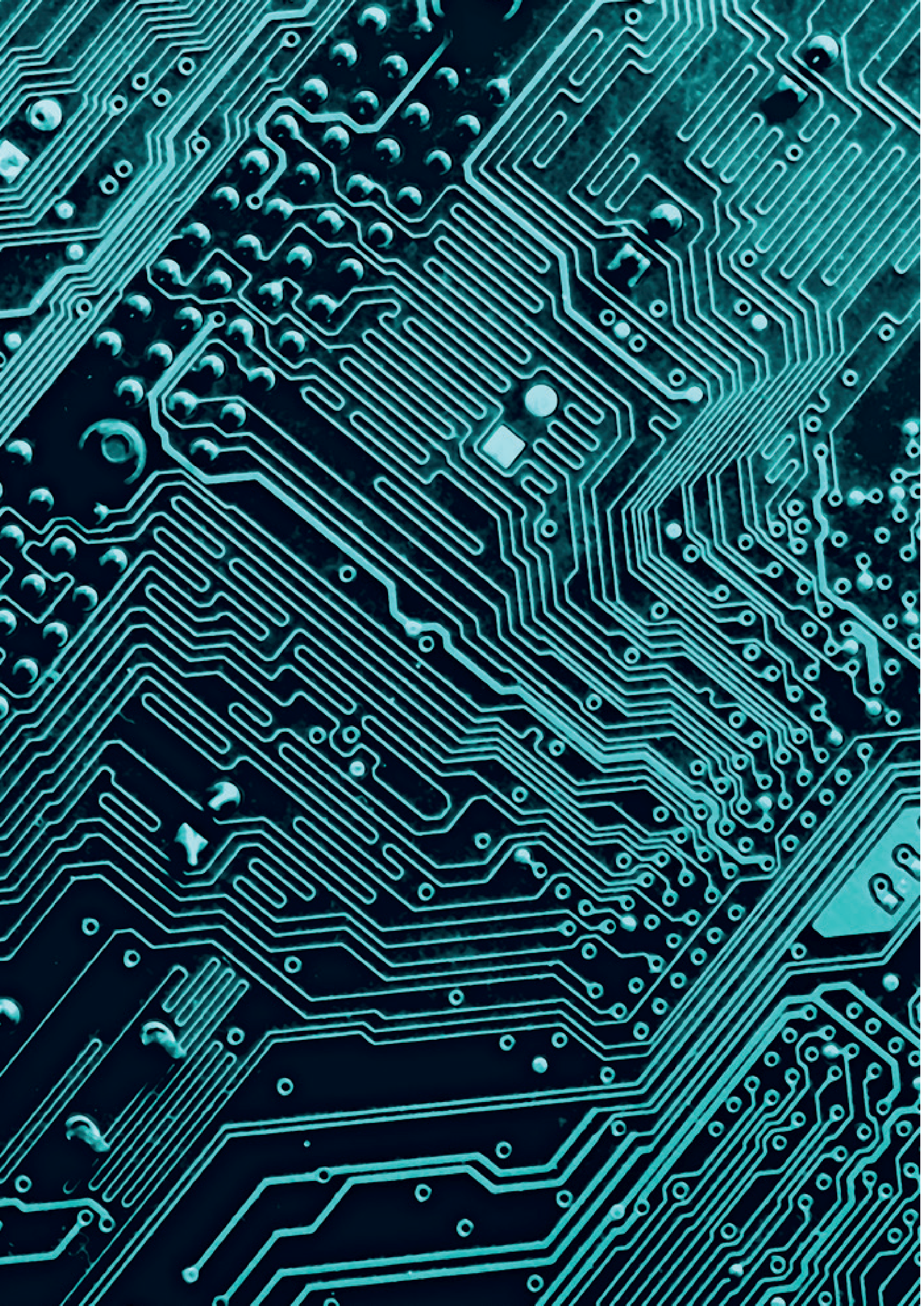

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