

Pascal's Wager

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Do you believe in God?

Whether you or do or do not, the seventeenth century French mathematician Blaise Pascal argued that you should, in what has become known as Pascal's wager. If God does not exist, belief in Him leads to small, finite losses. On the other hand, if He does exist, then disbelief may lead to the loss of an eternity in Heaven or indeed, the "gain" of an eternity in Hell. The rational man, Pascal argued, had nothing to lose by a positive belief in God but much to lose if he didn't (and turned out to be wrong).

The thought came to mind due to the return home last week of a colleague who had taken their annual vacation with their family on Rhodes in southern Greece. You will know from the hellish pictures on television what has been happening over there. Our colleague was very lucky to return before the fires started and our thoughts are with the tourist families and native Rhodians who are battling the consequences of extreme heat.

In many ways Pascal's wager applies equally to the impact of climate change. A large constituency of people both here and across the Atlantic flatly deny that climate change has anything to do with human impact, CO2 concentrations, and fossil fuel and therefore nothing can or should be done.

Pascal would argue that whether you believe climate change is man-made or not, the risks of not doing anything are far outweighed by the risks and costs of doing nothing. Effective investment today, as the Stern review noted in 2006, might well mitigate the damage of climate-change tomorrow, at much lower cost than in the future and therefore, rationally, those costs should be accepted and adopted today.

The recent byelection in Uxbridge was something of a local referendum on the costs of moving away from a carbon intensive economy to a carbon neutral one. At a time of high inflation and squeezed incomes the voters – if you like, the wisdom of the crowd – took the opposite view to Pascal. Mitigating the risk of climate-change tomorrow did not offset the costs of living today.

It is an impossible conundrum; human beings are hardwired to live in the present but, if climate-change is real, even if it isn't man-made, the consequences are ineluctable.

We know from experience and the findings of behavioural economists that people are quite capable of acting irrationally for long periods of time. Keynes even quipped that "markets can stay irrational longer than you can stay solvent."

The "rational economic agent" of neo-classical economics it seems is no more than a figment of the imagination of neo-classical economists. Nonetheless, benefits taken today do need to be set against costs incurred in the future and, oddly enough, corporate accounting has a method of dealing with the issue.

Companies that are well managed normally have sound policies with respect to depreciation. In the course of producing goods and services for sale, the assets that are used to produce those services will eventually wear out and need replacing. Therefore, a company's pricing policy must include a value that acknowledges the cost of replacing assets used during business sometime in the future.

Indeed, one of the factors we look at in company analysis is the rate of depreciation relative to capital expenditure. If capex is below depreciation, the company will eventually work its way into the ground, not normally the basis for a good long-term investment. (A change in depreciation policy is often a sign of corporate stress.)

A related concept is the notion of what economists call “negative externalities.”

Companies provide goods and services and in so doing impose costs upon everyone, not just the people they serve. Examples might include aircraft noise, sewage discharges into rivers, ubiquitous microplastic pollution, deforestation and, of course, CO2 emissions.

Arguably, albeit it is hard to say this in a period of high inflation, many goods and services may have been priced too cheaply, and therefore, recorded inflation has been kept artificially low, because those prices do not include a charge for what might be called “planetary depreciation” or the cost of mitigating those negative externalities. It is known as the “free-rider” problem.

There are two consequences.

Firstly, companies that take issues surrounding ESG (Environmental, Social and Governance) seriously will adapt more quickly to a world where the costs of planetary depreciation are visibly coming home to roost and will gradually enjoy a premium rating. Companies that do not risk becoming obsolete as consumers gradually change their own behaviours, whether on principle or for economic reasons.

Secondly, as companies begin to account for the costs of dealing in an environmentally challenged world prices will increase, and inflation is likely to stay higher for longer until a new equilibrium that accommodates the cost of planetary depreciation is established.

Whether you think climate change is real and/or man-made or if you don't, Pascal's wager suggests it would be rational to act as if, indeed, it is.

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