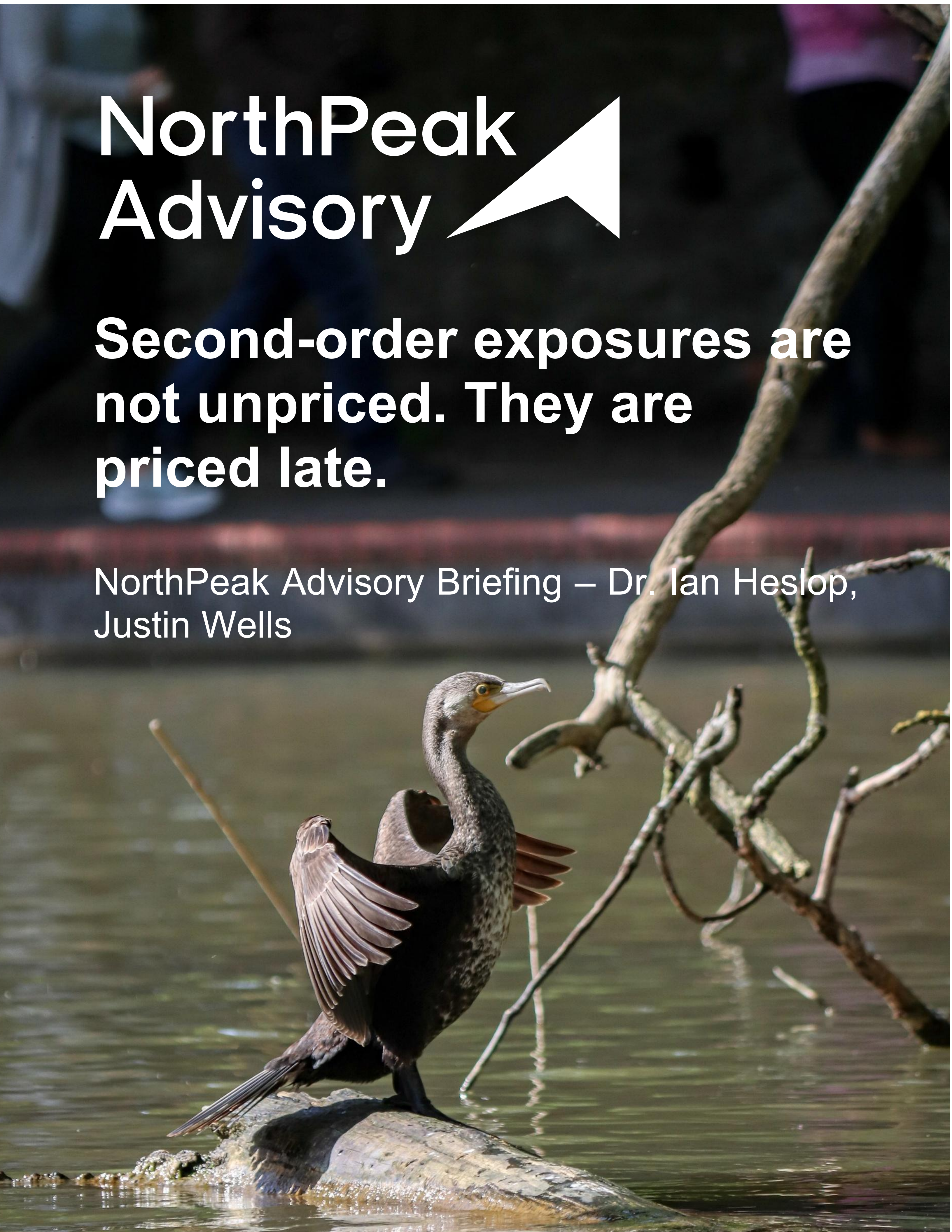
NorthPeak Advisory

Second-order exposures are not unpriced. They are priced late.

NorthPeak Advisory Briefing – Dr. Ian Heslop, Justin Wells



"Sustainability information is not an ethics overlay. It is where outcome volatility hides".

Howard Marks made second-level thinking famous by showing that the obvious reading of available information is rarely where advantage is found. NorthPeak Advisory applies the same discipline to second-order exposures: the overlooked sustainability signals, operational dependencies and hidden constraints that others misfile, discount or ignore. Read properly, they become commercially powerful evidence for asset managers and corporates. Miss them, and decisions are made with less than the complete picture, often leading to avoidable underperformance.

Second-order Exposures

Second-order exposures typically underpin a business but are not fully reflected in its financial statements. These are the capabilities, dependencies and constraints that shape a business's ability to generate and sustain cash flow. Much of this information is already available, often under a sustainability or ESG heading. For corporates, these exposures equate to real financial risk, with the opportunity to get ahead of the risk through planning. For investors, the opportunity is to find price-sensitive information before it is treated as a compliance matter, missed by deal teams, or ignored for ideological reasons. The problem often encountered is the information can be technical and is often overwhelming. A structured and considered approach, together with technical knowledge, maximises the accrued benefit from this information.

The availability of material information being overlooked

From a corporate perspective, second-order exposures create financial risk that can be managed if identified early. Revenue variability, cash-flow pressure or operational dependency can place stress on the business model and, at the extreme, threaten growth plans. The commercial value is clear: earlier recognition gives management teams time to act before small issues become value-damaging risks.

From the investment side, outcome volatility is where value is won or lost. In public markets it appears in share prices; in private markets it appears in revenue performance, margin delivery and exit assumptions. Second-order exposures give investors a better view of that range, helping them price risk earlier, focus diligence faster and build forecasts that are harder to surprise.

For an equity investor, the relevant outcome is the return realised at exit. That return rests on a chain of assumptions: growth, margins, valuation multiple, holding period and more. Each assumption affects the strength of the base case. Second-order exposures help test how stable those assumptions are by highlighting issues not visible in the financials. Customer concentration or key-person dependency does not create a new risk; it shows how much of the base case depends on a single condition continuing to hold.

For a credit investor, outcome volatility is driven mainly by impairment when financial distress emerges. Second-order exposures can improve forecasts by showing where that distress may arise before it appears in spreads or covenant tests. Often the issue is more practical: whether a critical supplier can be replaced, or whether a permit renews when needed.

This matters for both equity and credit. Some volatility is visible in financial reports; some is easier to miss because it sits in second-order exposures. Sustainability information is not an ethics overlay. Used well, it becomes a practical forecasting advantage: a way to identify upside resilience and downside exposure before either is fully reflected in the numbers. Indeed, as our colleague William Bryant wrote in his April 2026 article ‘The Real Fiduciary Failure is Ignoring Material Sustainability Information’, it remains a fiduciary duty to capture these financial risks.

Behavioural bias leads to missed opportunities

The raw material to understand second-order exposures is already available: management presentations, information memoranda, sustainability reports, board packs and contracts. It is often ignored or misfiled through a misunderstanding of the power that sustainable information has in improving predictions.

Sustainability frameworks are valuable precisely because they capture operational, workforce and environmental dependencies that do not sit naturally within financial or legal diligence. That creates an immediate opportunity: parse overlooked information efficiently and convert it into a sharper view.

A first pass usually sorts evidence into familiar categories: financial, commercial, legal, operational and, separately, sustainability. That is efficient, but it can let important facts pass through unnoticed. A supply constraint, customer dependency or permit condition may remain in the sustainability file rather than being recognised as the second-order exposure it is.

The opportunity is to read the same material without bias and do it early in the decision-making cycle. Here it helps shape diligence agendas, prioritise management questions and focus specialist advisers on the issues most likely to affect value.

Thames Water makes the mechanism concrete, even as the situation continues to unfold. Its environmental performance had been visible for years through sewage discharge data from the Environment Agency and dividend and investment information reported through Ofwat. In 2024, Moody’s lowered the company’s rating two notches into sub-investment grade. In May 2025, Ofwat imposed a £122.7 million penalty, citing wastewater failures and breaches of dividend rules. KKR later withdrew from a proposed rescue transaction, and the company has acknowledged the possibility of entering a government-administered process. The underlying data was not new, the commercial question was whether investors had priced it into the £19 billion debt stack before the rating agencies did.

The mechanism is easiest to see at that scale, but commercial opportunity is often found in smaller signals. Captured early, they improve pricing, diligence focus and downside protection.

The opportunity is clear

Once a second-order exposure is identified, it stops being abstract and becomes actionable. For corporates, it can be shared across the organisation, monitored and mitigated before it becomes a financial issue. For investors, it can move directly into the diligence scope, not as an ESG add-on but as evidence with commercial consequence: a sharper management question, a covenant test, a red-flag workstream or a specific line in the value creation plan.

That is the opportunity. The information is already there, hiding in plain sight. The teams that can translate second-order exposures into outcome volatility will ask better questions, focus diligence where it matters, price risk with greater confidence and identify value protection earlier than the market. In a competitive deal environment, that is not a sustainability exercise. It is an advantage.

NorthPeak Advisory helps investors and corporates identify, prioritise and act on these exposures before the market prices them. The information is already available to you: the next step is to make it decision-useful.

Webinar – 15 September. How to extract second-order exposures from the material you already hold, and turn them into decisions. **Register Here**.

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About the Authors

Dr Ian Heslop – Board Chairman, Advisor

Ian is the Chairman of NorthPeak Advisory and is consulting on the design and commercialisation of data opportunities for the company. His experience spans design and implementation of quantitative stock selection techniques together with portfolio construction within long only and alternative equity products. Ian was head of global equities and head of quantitative strategies at numerous firms over his time working in the City of London. He holds an M.A in Chemistry from Oxford University and a Ph.D. in Medicinal Chemistry from Edinburgh University.

Justin Wells, - Commercial Director

Justin leads the commercialisation of NorthPeak Advisory's ASAP and APIP platform. His experience spans investor, entrepreneur, and operator roles in scaling early-stage innovative technologies and drive adoption of disruptive technologies. In all these roles, he has leveraged his network in the sustainability start-up ecosystem.

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