Strategist's Corner
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Blue Suits and Greenflation

Exploring ESG* Integration

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To listen to the full conversation.

*__ESG__ stands for environmental, social and governance. ESG criteria can be considered when evaluating investments.

Thinking about ESG: Is it an output or an input?

- The industry often talks about ESG today as if it's an output. For example, many value-based clients want to exclude certain sectors, industries or companies from their portfolios. For many asset managers, if a client wants a blue suit, they give them a blue suit.
- I'd argue that ESG is an input, just like any other fundamental input. As an active fixed income investor, when you look at an issuer, you think about business strategy, the sources of revenues and uses of cash, the issuer's credit profile and the chance for a downgrade or an upgrade, the liquidity of a bond, the ability to trade it in the future and its relative value. ESG is another factor to consider.

ESG as a nonfinancial factor

- While ESG is a nonfinancial factor, we analyze it because it's a risk mitigation tool. If an ESG risk manifests, it can create financial materiality that leads to a substantial drawdown.
- You need to understand how this nonfinancial factor risk could become financially material. Will it be a hit to revenues or increase expenses and be a balance-sheet liability in the future? Understanding ESG factors should be part of your holistic investment thesis. That's how MFS does it.

Material factors, time horizons and themes: Incorporating ESG into fixed income research

- As a fixed income research analyst, the most exciting part of my job is working alongside the credit analysts, helping them understand which ESG factors may be material. For example, in the oil and gas industry, the environment pillar is extremely material because of climate transition risk. Will there be a carbon tax in the future? If demand declines for fossil fuels, how will it affect the future of these companies?
- We believe the most important pillar for banks, financial institutions and service companies is the S pillar — human capital, customers, product quality and safety. Those are important risks for services firms.
- The governance pillar is something the data analysts have always thought about even before it was formalized under the E, S and G.
- Another aspect is recognizing that bonds, unlike equities, have a finite time horizon. You must know the horizon of a particular ESG issue. If you own a 3-year bond and there is an ESG risk factor in 10 years, will it affect the valuation? Is there a chance that a risk will become an actuality?

- Themes are a third aspect of ESG. They can cut across multiple sectors, yet their impact is particular to that sector. Take auto manufacturers and oil and gas producers. Autos are trying to move away from internal combustion engine vehicles (ICEs) to electric vehicles (EVs) as transportation is one of the biggest contributors to carbon emissions. Energy companies are very good at project development — deploying capital and managing capital risk. Those skills translate to renewable energy projects. Some oil and gas companies are increasing their portfolio of renewables and slowly transitioning away from fossil fuels. Others are trying to make their fossil fuel production cleaner through methods such as methane abatement.

Understanding greenflation*

- The 60s and 70s was a time of global industrialization. Companies were focused on maximizing profitability at any cost, sometimes to the detriment of the environment or their stakeholders (governments, consumers and employees).
- Fast forward to today. Stakeholders are realizing that they have a part in minimizing damage to the environment. Companies are realizing that they need to treat their employees and their communities better. However, becoming better corporate citizens generally comes with a cost that someone must pay.
- Companies can pay for it themselves, or they can pass it on to the consumers. While consumers might be willing to pay more for a sustainably produced premium product, in some cases, there is no alternative (TINA). If companies don't become sustainable, they will likely go out of business because their competitors will use sustainability as an advantage.
- Greenflation is already having an impact and will emerge as companies spend on sustainability. EV production requires metals such as nickel, cadmium and copper. Demand for these precious and other base metals will soar as demand for EVs grows. Pricing has already been impacted.
- The third part of greenflation is physical climate risk — once-in-a-hundred-years floods occurring every decade. If crop-producing land experiences more weather shocks, the productivity of that land goes down, pushing food prices up.
- And finally, there's deglobalization. Onshoring supply chains is an extra cost. There is a connection between deglobalization and ESG. Are you reshoring production from hostile countries to friendlier regimes? If so, you're managing governance.
- We believe that greenflation — whether good or bad — is inescapable, and these conditions will lead to higher prices, higher production costs and higher expenses.

Who'll pay for greenflation?

- Starting in the 50s and 60s, any chart comparing the growth of the Dow Jones Industrial Average or the S&P 500 Index to Gross Domestic Product (GDP)[1] has looked like a massive alligator mouth. This growing divergence has been caused by profit maximization that has come at the expense of stakeholders, the labor base or the environment.
- Yet now it's reversing, driven by the cost of capital, onshoring, the transition from single-use to recycled plastic, etc. — the move to sustainability. Someone has to pay for it.
- The rebuttal that is often heard is that consumers will be the ones that pay. But consumers typically find substitutes, often from companies that are operating in a more sustainable way.

*__Greenflation__ is the inflation caused by increased capital investment to mitigate and/or adapt to climate change.

- We are seeing it already. The demand for EV trucks is higher than ever. When diesel costs six dollars a gallon and gas five, an EV truck looks very appealing. Oil and gas companies have looked at the horizon and realized that demand for their products will fall. Over the past decade, they've cut capital expenditures (capex) and, cut back on investments in new oil fields and foregone new exploration initiatives. In our view, that supply shock — high prices — will continue, making EVs look even more appealing.
- However, people and markets have always adapted. We think we'll adapt to this new regime of higher prices, deglobalization and wider supply and demand gaps. But it's not going to be free. In some cases, consumers will pay. In others, companies will take a hit to margins.
- That's why ESG integration, as an input, matters so much: discerning between what's financially material and what's immaterial and determining if it's priced in. Our fixed income credit analysts are thinking about how greenflation — this extra cost — is directly affecting revenues and indirectly affecting earnings before interest, taxes, depreciation and amortization (EBITDA) along with free cash flows and how it could permanently decrease demand for their product.

Endnotes

[1] Gross Domestic Product is a broad measure of economic activity. Sourced from the Bureau of Economic Analysis and the US Department of Commerce.

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