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All Angles
March 2024

Simplicity and Complexity

Striking a Balance in Sustainable Investing

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Should investors care about impact?

A simple question with an obvious answer. Of course they should! Every investment has an impact.

This is not groundbreaking logic. Financial institutions and corporate actors directly and indirectly contribute to the conditions of our shared ecosystems. As long-term investors, how could we not care about the continuing viability of the issuers we invest in or the system in which they operate? If companies fail to account for the roles of all stakeholders — employees, customers, suppliers, communities and the environment — in the creation of economic value, they may ultimately lose their license to operate and everyone, investors included, will be the poorer for it.

Sustainable investing — simple in theory, confusing in practice

It's often in the best interest of investors to be thinking about the impact issuers have on society and the environment. This is the basis of sustainable investing, and it's elegantly simple in theory. In practice, it's become a contentious and controversial topic over which the investment world has managed to tie itself in knots.

Politics has played a part. Sustainable investing, and in particular the consideration of environmental, social and governance issues (ESG), has been the topic of much political debate. But we can't lay the blame entirely on political misapprehensions. The investment community has done a good job of confusing the issue on its own.

Our industry is inundated with a dizzying array of narratives around ESG, impact investing, sustainability and other related concepts. These narratives ultimately lead to the question of whether sustainability is about making better investment decisions or making a better world.

There doesn't appear to be a right answer, or at least a complete one.

Perhaps this is because we're asking the wrong questions. Humans are binary thinkers. It's only natural for us to seek structured, measurable ways to approach complex problems. Yet my experience has been that complex problems require nuanced solutions. It's inherently difficult to reconcile value creation with environmental and social preservation in an economic system that operates around short-term shareholder gains. This is at least in part a result of our industry's excessive preoccupation with short-term financial results and the so-called "pacification" of capital. Not factored in are the social and environmental externalities detrimental to the world and the long-term economic viability of many business models.

What if we envision instead capital allocation as a tool to promote a system that prioritizes financial wellbeing while helping to build a shared prosperity and a healthy planet?

Challenges posed by the current approach to sustainability

We like to think this goal isn't out of the reach of our collective remit. The recent movement around sustainability is driven at least in part by the recognition that we need to think about things differently. But before we can do this, we first need to reflect on the challenges that have come with how we approach sustainability today.

The first is around implementation. For many, sustainability is about merging certain investor values with financial objectives. Often, what ensues is a narrowing of the investment universe: Only invest in "good" ESG companies and ruthlessly exclude those deemed objectionable. This is problematic for a few reasons, not least because there is a difference between excusing yourself of something you don't wish to partake in and actively pursuing change. This approach can also inflate the degree of impact being achieved, and risks equating portfolio impact with real economy change.

For example, in public markets, the vast majority of companies are net distributors of capital. They return far more through dividends and share buybacks than they extract through equity issues. In the secondary market, trading out of a high emitter into a lower emitter may help to reduce your portfolio's carbon footprint and might make it "values aligned" in an attribution analysis, but it has zero bearing on the reduction of real-world CO2 emissions, past, present or future. Surely the real economy must lead and the portfolio statistics will follow. We don't believe optimizing for carbon emissions at the portfolio level will have any impact on the real world.

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Moreover, this approach often results in tradeoffs. As investors seeking financial returns, why would you devise a strategy that ignores critical components of the investment puzzle such as competition, supply and demand, profitability, capital intensity and valuation? A wind turbine manufacturer may play a critical part in the energy transition, but if barriers to entry are low or valuation is full, it may prove a terrible investment. Equally, if an oil company is cheap enough, regardless of the outlook for oil demand, it may be a great investment.

If you really wanted to create an impact in public markets, your best strategy might instead be to create a portfolio of the most-polluting companies and then agitate for change, but we suspect that this would deliver only a modest impact and poor financial returns and could raise issues in light of the investment manager's fiduciary duty. Alternatively, there is scope to have a positive impact by investing in companies with an explicit social or environmental purpose, but only in the field of early-stage angel or venture investment, where companies constantly need fresh capital to survive and prosper.

The second challenge posed by the current approach to sustainability underpins the first: Most of the issues we're trying to analyse are intangible in nature and can't be synthesised. There's a plethora of existing and emerging standards, metrics, frameworks and guidelines aimed at helping us measure ESG factors. But how can it possibly make sense to impose universal, predetermined templates on the investment community to assess the sustainability of every investment when so much of it is immeasurable?

For example, measuring a company's staff turnover or wage disparity might give us an indication of its corporate culture, but would it present a complete picture of the employee, supplier and customer experience? Of course not. Intangible factors are by definition unquantifiable.

And yet the broader industry isn't only desperately seeking to quantify a wide range of ESG characteristics but also to transform those metrics into aggregate scores and ratings. The single-scoring of ESG is an example of overengineering and oversimplification in our market in recent times — and thereby presents a fantastic opportunity for active investors and asset allocators who are keen to roll up their sleeves, do their own analysis and come to reasoned judgements on where to invest.

To demonstrate this, consider the following thought experiment involving a hypothetical electric vehicle company that you're looking to assign an ESG rating. Setting aside mediocre governance and controversies involving the founder and executive management for a moment, in your view this company is an exceptional industry leader and pioneer on environmental issues and has done more to directly influence the trajectory of low-emissions vehicles than any other company. However, research shows that the company may have disregard for its workers, and it faces allegations that it treats minorities poorly. It also has a poor worker safety record. How do you assign an overall ESG score ranging from 0 (bad) to 10 (good)? What does that score actually mean? How should the company interpret its score, and how can it improve it? How much worse can it treat its people per ton of emissions saved?

If you were to ask anyone outside the investment industry these questions, they would think you were deranged to frame an issue this way. In a similar vein, we reject the notion that you can segment the investment universe into "good" and "bad" actors. The temptation to do so as binary thinkers is understandable, especially as resource constraints and social inequalities grow increasingly strained. But much as we might like to live in a Tolkienesque world of hobbits, elves and ents on the one side and orcs, trolls and black riders on the other, the real world is more nuanced than that.

Consider these examples:

- An industrial gas company is a huge emitter of CO_2 but also a critical enabler of the energy transition. In practice, the consumer emissions it helps to reduce outweigh the emissions it creates.
- A chocolate company's supply chain is riddled with child labour issues, but its suppliers are small subsistence farmers in West Africa, where children working on their parents' farms is both a cultural norm and an economic necessity.

If you accept the premise that these are complex questions with no right answers, then it becomes clear that using the investment system to improve the world — assuming that's your mandate — is a far from straightforward endeavour. And of course, for most asset managers, including MFS, the mandate isn't saving the world but looking after our clients' savings.

Why investors should embrace complexity and imperfection

When faced with complexity, the natural tendency is to try to escape it, but instead we need to embrace it. Sustainability presents itself in many shapes and forms; some are brightly lit, others darkly concealed. Often, the more we dig into these issues with companies, the more complicated they become. Alongside complexity, we also need to embrace imperfection. Making judgments and reaching conclusions without having the complete picture is part and parcel of the investor's job.

At MFS, we have an investment team of over 300 people, most of whom spend the bulk of their time trying to deepen their understanding of equity and fixed income issuers around the world. It's an endless, challenging and often frustrating yet strangely addictive process. We try to understand as much as we can about the critical components of the investment puzzle: the key revenue and margin drivers, the cash flow and balance sheet characteristics, the competitive and regulatory environment, management and corporate governance, and the environmental and social factors that could have a material bearing on long-term value. We do this because we have a clear mandate: We must put our clients' financial interests first. But when — by emphasizing the importance of long-time horizons and business models that consider sustainability — we can, in a small and immeasurable way, help build a more durable economic ecosystem, then we will.

None of this is easy. There are no simple answers. Within the team there is constant disagreement: around management quality, disruption risk, competitive edge, regulatory risk and critical sustainability concerns. This disagreement doesn't concern us; on the contrary, it reassures us. We recognize that there is no substitute for actually engaging the brain and trying to use judgment as well as objective data to arrive at a conclusion. When we all reach exactly the same conclusion, something could be seriously wrong.

This sentiment also rings true for the challenges described above. We don't need to converge around widely accepted principles of impact investing, sustainability and ESG in order to recognize that if we want our ecosystem to endure, we have to play a part in correcting the imbalances of today. We do need to be honest about the limitations of how we operate today, though. Working through this will likely require more creative thinking than we as investors are used to, in addition to diligent, contextual analysis, judgment and debate. All of this will require patience and a long-term focus.

If we and other investors can demonstrate that making money and doing good aren't mutually exclusive — and indeed, can be mutually reinforcing — we could transform the way individuals and investors think about capital allocation. This pursuit is arduous and far from straightforward. There are no shortcuts and no magic bullets. But in the words of John F. Kennedy, we should do these things not because they are easy but because they are hard, because the rewards could be spectacular. There is an opportunity for MFS and the investment industry to redefine itself, and by so doing create enormous value for clients, communities, employees and shareholders. I hope that collectively we have the imagination and courage to rise to the challenge.

All Angles Podcast

March 2024

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