Borderline Traceable:
Tariffs Meet the Transparency Test

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Bentley Kaplan

Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society and corporate governance effects and are affected by our economy. I'm Bentley Kaplan, your host for this episode. On today's show, we're going to talk about a global economy that is feeling the effects of a sudden onset of tariffs and broader trade uncertainty, because it is in these times of uncertainty when the alternative data that we collect for our sustainability assessments helps to draw clearer pictures of risk and opportunity. And we're going to look specifically at supply chain traceability. It's a theme that has long resonated with sustainability-focused investors, but it's also one that may suddenly be relevant for a much wider investor audience. So thanks for sticking around. Let's do this.

On April 2nd, the US government announced a baseline 10% tariff on all goods entering the US and higher tariffs for around 60 countries or trading blocks. The announcement left companies, investors, and markets in general scrambling to figure out the implications and head off the biggest sources of risk. Since then, the US has scaled back or temporarily suspended a big chunk of these tariffs. And while that brought some initial reprieve for markets, longer-term uncertainty is looking sticky. It's hard to know if or when some of these tariffs may be reintroduced, and more broadly how the shock may ultimately reconfigure global trading relationships with and outside of the US. On our episode last week, Mike spoke to our colleague, Xinxin Wang, about how early data is showing that ESG indexes those with criteria that focus on companies that have higher ESG scores or specific sustainability characteristics have outperformed their parent indexes in terms of cumulative active returns. It's a trend that has repeated itself over historical time periods, multiple studies, and notably during the uncertainty of the COVID-19 pandemic.

And there are good reasons why companies that are good at managing their sustainability risks may be coping better during times of stress. From better governance and risk oversight to more efficient use of natural resources like water, better workforce management practices, or even more comprehensive supply chain traceability, all of these things add up to more resilient companies. And there is a whole range of this type of alternative financial data that we capture in our ESG rating, data that can be extremely handy during unexpected market shifts, like a pandemic or a shake-up in global trade agreements. When large tariffs suddenly affected a whole range of imports entering one of the world's biggest markets, a lot of investors might've been thinking about supply chains, where inputs to a company's final product are being sourced from and how many layers sit between them. And it's a topic that has long been central for our sustainability assessments and for good reason. My colleague, Aura Dron, out of MSCI's London office explains why.

Aura Dron

So when we talk about traceability, we're really talking about understanding where your materials come from and how they're made. It's about having that line of sight into your supply chain so you can spot risks before they become real problems. Think about things like palm oil linked to deforestation or cocoa associated with child labor, or factories that don't meet basic labor standards and traceability can help shine a light on those issues. Take palm oil for example. It's in everything from snacks to shampoo, and it's also been tied to deforestation and land rights conflicts, especially in Southeast Asia. If a company doesn't know exactly where its palm oil is coming from, there is a risk it could be sourcing from plantations that were illegally cleared or that displaced local communities. But if the company has a solid traceability system in place, it can prove that its palm oil comes from certified, sustainable sources. That means it can avoid reputational risks and actually support better outcomes for people and the environment.

Traceability also matters when it comes to regulation. The EU, for instance, now requires companies to prove that their products containing palm oil or soy, or beef aren't coming from deforested land. And in Australia, modern slavery laws require businesses to report on how they're addressing forced labor in their supply chains. So if you're not tracking where your materials come from, you're not just exposed to reputational risks, but regulatory risks as well. And there's one more big reason why traceability matters, and that is resilience. In a world where supply chains can be thrown off by anything from political instability to the natural disasters to a sudden change in trade policy like we are experiencing now, knowing where your staff comes from gives you an advantage. If you don't have the visibility, you're going to be slower to react and document delays, product shortages or unexpected costs.

Bentley Kaplan

Right, so knowing what company source and from where is important to different investors for different reasons, because what is being sourced, where it comes from and what activities are happening at source Locations all translate into different risk profiles. And if you know the specific locations where things are being sourced from, then you really can do a lot with geospatial data. You could plot these source locations against things like physical climate risks. So you can figure out whether upstream production facilities face things like high levels of flood risk or if timber plantations are in regions where water scarcity is getting worse. You can even figure out if supply chain activities are happening in areas with sensitive ecosystems. But there's a snag here, because you can't do anything quite so flash if you don't know enough about a company's supply chain, which is what brings us back to Aura, because in the wake of the US tariff announcements at the beginning of April, Aura took a look at how well companies in different industries are able to put in this very first piece of the supply chain puzzle, supplier traceability.

Aura Dron

We wanted to see which industries have better traceability, and we looked at over 700 companies across multiple sectors, and we found significant differences in traceability performance. Industries like retail, consumer discretionary, electronic components or restaurants reported some of the lowest levels of traceability. These are sectors with sprawling, multi-tiered global supply chains. So it is not a surprising finding. For consumer discretionary, retailers in particular, that includes everything from apparel and accessories to electronics and household goods. The breadth and fragmentation of the supply networks can make visibility a major challenge for these industries. On the other hand, you have companies in the paper and forest products that stood out with the highest levels of traceability, and that may be due to the more localized or vertically integrated supply chains, which are often easier to monitor.

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Right, so for some industries, the challenge of being able to trace your supply chains is going to be harder than for others. For those that are only a step or two removed from their producers or have only one layer of supplier, it might not be so hard. Aura found that 70% of paper and forest product companies could trace more than 60% of their suppliers, of which 43% could actually trace all of their suppliers. But most industries fall well short of this.

And that’s not for lack of trying. Some investors and regulators and non-profits have been pushing for better traceability. For things like seafood, beef, palm oil, textiles and footwear, supply chains can have sizable negative impacts across both environmental and social dimensions. And these tracing efforts have yielded some progress, but there’s still plenty of work to be done. And that is especially the case if you’re relying on multiple layers of components from different regions which ultimately find their way into fully assembled smartphones, well, tracing each and every piece back is a herculean task.

If you're relying on multiple layers of components from different regions, which ultimately find their way into fully assembled smartphones, well, tracing each and every piece back is a Herculean task. Unsurprisingly, Aura found that of all the electronic component companies that we assess on supply chains, three out of four did not report on traceability, and the same went for consumer discretionary companies in the retail sector.

Taking this type of industry-level approach can certainly help in identifying where unknown risks may lie or where to dig further. But Aura also told me that there are specific steps that companies might be taking and reporting on to better manage potential supply chain risks. In addition to the initial work of mapping supply chains and knowing their suppliers, companies might also be looking to adopt a variety of practices, including diversifying suppliers and sourcing locations to avoid over-reliance on a single country or supplier, building in backups for preferred suppliers, developing contingency plans and deliberately building strong supplier relationships.

For those companies that already are industry leaders in areas like this, well, tariffs might create a significant headache, but they’ll probably know a lot about where their suppliers are and where alternatives might be. Contrast that with companies that don’t have clear lines of sight into their supply lines. They’ll be dealing with big, painful operational questions, as well as many that will suddenly be coming from investors of all stripes.

And with all of these short-term pressures, I know it's hard to think about now, but there are going to be longer-term questions as well, because there will be companies taking action today to secure new suppliers that meet cost requirements or that avoid big new tariffs. But if supply chains are suddenly reconfigured, that might also unintentionally lead to a rise in other sustainability risks that had been carefully calibrated in long-established supply lines, which is why Aura and several of my colleagues will be watching this recalibration very carefully.

Aura Dron

Yeah, exactly. In the short-term, companies might respond to trade pressures like tariffs by switching suppliers, but that shift can come with trade-offs. A new supplier might help avoid the tariff, but it could also introduce new environmental or social risks. Consider a food manufacturer responding to rising soybean tariffs by sourcing from new regions. If those new suppliers operate in ecologically sensitive areas without proper safeguards, the switch could heighten deforestation or biodiversity risks, and potentially putting the company at odds with its own sustainability commitments. If products start getting redirected away from the US market, we could also see a big shift with more goods flowing into places like Europe. And in that situation, European producers might be tempted to go for cheaper options from further afield, especially in this challenging economic environment. But that comes with trade-offs. It can mean longer foot miles, a bigger carbon footprint, and potentially greater risks around labor issues, like poor working conditions or modern slavery.

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So maybe more questions than answers for now, but that's probably a fair reflection of where things stand as of mid-April. There's a lot that's still moving and it's hard to know where things will settle, but as Aura points out, longer-term changes are no doubt rippling out ahead of us. If there's any comfort to be had, it's that in times of great uncertainty, having access to alternative data sets, the kind that we collect for analyzing company resilience and sustainability can offer new and helpful perspectives.
And that is it for the week. A massive thanks to Aura for her take on the news with a sustainability twist. If you enjoyed this content, then do go and check out MSCI.com's dedicated research hub for all things tariff related. It's titled, “Navigating Uncertainty Tariff Implications: What Global Shifts Mean for Decision-Makers.” As I'm recording this, there's already some great stuff on there covering private equity, listed equity, multi-asset classes, but there's more on the way as the situation develops and unfolds. And also, do want to say thank you very much for tuning into this episode. If you like what we're doing, then let us know. Drop us a review, rate the show on your platform of choice and tell a friend or a colleague all about us. Thanks again, and until next time, take care of yourself and those around you.

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