The Conflict Within ESG.

Speaker 1: What's up everyone? And welcome to the weekly edition ESG Now, where we cover how the environment, our society and corporate governance affects and are affected by our economy. I'm your host, Mike Disabato, and this week we talk about the conflicts that can be present in ESG investing. For example, what happens when you have a company with a sustainable environmental policy, but an unsustainable labor policy? Thanks as always for joining us. Stay tuned.

There's a story moving around the headlines this week about a restaurant that just closed called Noma. Noma is based out of Copenhagen, and it did something that is close to my heart. It boasted itself as a fine dining restaurant that used only ingredients local to the region and operated in the Nordic region. And so Noma was said to invent what's called the New Nordic, a hyper-local, eco-conscious food movement that the culinary world went wild for. The two Danish chefs that opened the restaurant, named René Redzepi and Claus Meyer, were lauded as visionaries for fixing the waste inherent in the fine dining industry. And to add to that, people thought they had moved away from the brutal labor practices that many restaurants had become famous for. But then Noma closed, and people that worked there were interviewed and didn't have the nicest things to say about its working culture.

The stories added to an onslaught of testimonies of late that fine dining is rotten at its core when it comes to labor management. Yet New Nordic, the hyper-local, eco-conscious food movement that Noma helped push into the luxury scene, that isn't rotten. That's an important push, one that should be lauded. Except can Noma, which has been accused in the Financial Times, the New York Times, and other news organizations, of industry practices that might be called labor abuse, can Noma be lauded for helping promote more sustainable practices in their supply chain while using unsustainable labor practices? And as I was reading this and thinking about that question, I was thinking about how value and impact investors often have to grapple with those sort of trade-offs, where you find a company that is providing some sort of positive impact using processes that are exploitative or unsustainable or whatever you want to call it.

So I thought today I would examine the trade-offs present in two important industries that we cover, clean energy and healthcare, and discuss what those trade-offs are, what they mean for the companies and those sectors, and ultimately what they mean for investors trying to pool together companies into a portfolio that they can then invest in. So let's start with solar energy. If we were to reach net zero by 2030 or 2050, solar has to be an integral part of the world's energy system. The industry needs to grow quickly, and the energy needs to be affordable in order to achieve that goal. And there's a region in China that has become a hotbed of growth and controversy for the industry. And so to talk about all that, I called up my colleague Matthew Lee, and I asked him first to kind of give me the 101 on why this region in China has become so important for the growth of the solar industry.

Speaker 2: China actually is estimated to account for 60% of global lithium processing as well as 79% of polysilicon. So these key raw materials are processed in China at a overwhelmingly high rate. So that concentration has led to China accounting for 97% of the world's global wafer manufacturing capacity and 85% of sales. This is according to the International Energy Agency in 2021. And that consolidation means you have firms like LONGi Green Energy Technology, JinkoSolar, Trina Solar, JA Solar that are very well positioned to take advantage of an increase in global demand for more solar panels. The IEA, again, in their scenario for net zero by 2050, calls for about a 21% annual growth in solar generation to reach our needs. And so they're very well positioned to continue taking advantage of this growing demand for solar energy.

Speaker 1: So before a solar panel appears on a rooftop or solar farm, you first have to take this melted mineral base of harvested silver, lithium, quartz and polysilicon and melt them into what are called ingots. And then those ingots are made into wafers, which are then cut into the cells and panels that we're all familiar with when we see pictures of solar panels or see solar panels in person. And for 97% of the world's wafers, they are made by those companies that are domiciled in China that Matt just mentioned, LONGi Green Energy, JinkoSolar, Trina Solar, JA Solar, which is great because as we know from Econ 101, in manufacturing, economies of scale are important to keep costs down. And for renewable energy especially, the cheaper it can be made, the better because a rise in energy costs hurts the most vulnerable people in our communities and further entrenches reliance on fossil fuels.

Speaker 2: On the other hand, Bloomberg has reported back in April of 2021, and subsequently we've seen in May 2021, Sheffield Hallam University report connecting these companies I just mentioned as having supply chain exposure to polysilicon refineries that use forced labor in some instances have been linked by a state-run employment program in China in the Xinjiang province.

Speaker 1: And it's moved from a reputational problem to a regulatory one, especially for downstream solar panel manufacturers and developers.

Speaker 2: Legislation such as the Uyghur Forced Labor Prevention Act in the United States was passed last year, and it presumes all products manufactured in a region that this US inter-agency forced labor enforcement task force has identified, they're presumptively banned. The language they use is unless you present clear and convincing evidence that your products in that supply chain did not use any forced labor at all, you're presumed to be using or having links to forced labor, and therefore cannot be imported into the United States. And Axios actually just came out with an article this month, January 2023, that US Customs and Border Protection has seized about $1.3 billion worth of these types of solar panel imports and that this has been a 63% increase in Q4 of 2022 in terms of the solar panels they've been seizing.

Speaker 1: Seizing solar panels that when used would lower our collective emissions in replace of fossil fuels. That is where the tension comes in. Everyone from the IPCC to the Union of Concerned Scientists to the IEA, everyone says we need solar panels to slow this climate catastrophe. Yet a lot of solar panels are made in a region facing serious allegations of forced labor, and it's very difficult to know who's involved and who is not. And if you wait for supply to shore up and become more diversified, made by more companies, you might be waiting a while because the market dynamics of solar are concentrated to one area, and that area is going to be able to make a lot of solar panels more quickly and cheaper than you can.

There are efforts by companies like Hanwha Solutions, a South Korean solar panel manufacturing company, to diversify the supply chain, but decoupling a supply chain takes time. For investors, this means having to decide right now, which is the higher priority in their investment decisions, clean energy or possible human rights violations? Investing in data and due diligence can help parse things a little further. It can put certain companies more clearly on one side or the other, but it often comes down to a judgment call based on imperfect information.

And that sort of judgment call definitely is there for the healthcare industry. Healthcare is a special sort of beast when it comes to public companies because it combines the profit incentives of the market with the need by our society for better access to healthcare, that in an industry where any safety issues with their products could mean people could get seriously hurt. So this is a doozy. And so here's Namita Nier, who covers healthcare for us, to tell us more about these sort of trade offs, these sort of complications that we just talked about for the solar industry.

Speaker 3: What we see is there are a number of companies that have to walk this tightrope between maintaining product safety and quality and improving access. And it's not as easy as you think. If you have breakthrough therapy, it's one of a kind therapy that has been approved for diseases, for example, like Alzheimer's or something. Then in that case, a company might want to recoup all these R and D costs and make a hefty profit on it. And what usually happens is that the company puts a really big price tag on it.

Speaker 1: And then immediately, that price tag shuts out some market participants that may need the lifesaving drug. Insulin manufacturers are a good example of this, especially in the US. These companies are making an essential drug. They have good quality controls around that drug, yet they are pricing people out that need their drugs to live, and are now feeling the heat because of this pricing, the companies are, from regulators on their pricing controls. They're also pharmaceutical companies or biotech companies that have the opposite issue, where the drugs are priced more equitably, but their quality control and safety processes are lacking.

Speaker 3: For example, the Indian pharma manufacturers are a very good example of manufacturers that have drugs that actually meet the needs of a majority of the population. For example, cardiovascular drugs, oncology drugs, and these are all generics, which is a value proposition, right? Because that would be an affordable drug. But unfortunately, there are a lot of lapses in terms of product safety and quality with these companies, which has ended up with them having some of the highest intensities with respect to recalls and that with respect to severe recalls and for FDA Form 83, which they receive when their inspections of their facilities bring out deficiencies in quality. So this would be a very good example of companies that actually have the products that would make a difference to the healthcare needs of many, but the product quality issues are hindering sort of their value proposition.

Speaker 1: There are benefits for getting both right. If you can offer drugs that more people can afford, you as a company can enter more markets, serve more people become widely available.

Speaker 3: The differentiator for a company, once it has the requisite product safety and quality mechanisms in place, is access is a way an avenue to explore newer markets. It increases the profitability of a company in the long run, and it's also a sustainable act because when there are the majority of your population, the target population for a drug, is residing in middle income or low income countries, then making it available to those through different mechanisms, it could be through direct private markets or through the government channels or through multilaterals, is actually a winning proposition for a company as well.

Speaker 1: Still, there are not many companies out there that excel at both. Only around 20% of the biotechnology and pharmaceutical companies that we cover do well at both developing vital drugs and making them more easily available to the world. Some of the big ones in that list include Novartis, AstraZeneca, and GSK, but each of these companies also come with some sort of controversy on pricing and access. So the judgment calls on this, on solar, on healthcare, have to do with what priorities and constraints you have on what you do with your capital. That might change for an ESG investor compared to a values and impact investor, compared to other folks that just have different sets of priorities. When those judgment calls begin to be used in building portfolios, you start to understand how they manifest themselves in the aggregate. Because as my colleague Rumi Mahmood is about to tell you, sometimes you have to settle for a little less in one category for a little more in another.

Speaker 4: Common example is in a lot of gender equality and diversity funds, what we see is that optimizing exposure to companies that have a lot of good workplace gender equality and diversity policies or high female board participation and metrics like that at the fund level has resulted in other metrics such as carbon emissions, carbon intensity going up. So this is a simple example where optimizing, let's say social parameters, has resulted in the detriment of the E parameter.

Speaker 1: One of the reasons for that is many of the gender-equality focused funds out there have a large cap bias. A large cap company is typically one that reports on diversity and inclusion and gender and equality and all that, versus smaller firms that don't often report on those metrics. And larger firms on average emit more than smaller firms relative to given sectors. This is just one example of how trade-offs can complicate the investing process. Another is when a trade-off requires you to limit your investment universe, where there aren't enough companies to choose from, and you find yourself with all your eggs in just a few very similar buckets.

Speaker 4: So for example, if we say, take a highly impact focused investor who wants to be net zero aligned, for example, and wants to primarily invest in firms that are EU taxonomy aligned and have more than half of revenues coming from products and services addressing environmental objectives, well, the investible universe becomes very small pretty rapidly to a handful of names limited to wind and solar energy firms. And that, of course is quite an extreme example, but the point being that a common trade-off in ESG investing sometimes when the preference is to be highly aligned to a certain concept or set of principles or value or ideal in an impact investing context, that can lead to a concentrated portfolio and a loss of diversification.

Speaker 1: Losing diversification is toxic to most institutional investors, most big investors. The E-investment policies that they have balk at the idea and the fiduciary duties that they carry often require them to have some sort of diversification else they lose their institution's money due to one or two poor bets, leaving people without pensions or retirement accounts. This is different for retail investors. Retail investors can, if they want to, stomach a lack of diversification in their investment portfolios, and they can take on much more aggressive impact positions that limit their investment pool. Yet the real complication here that we must grapple with all the time within ESG and the ecosystem that ESG encompasses is not whether it is possible to avoid trade-offs. It's knowing that they exist and why they exist. And then you can understand where your limits and your priorities are as an investor, and that's as important as knowing, in my opinion, what sectors you want to allocate to and what you are using your capital for.

If the first part of the conflict is understanding the trade-offs and complications of your investments, then the second part is what you do about those complications and trade-offs. If I'm a values investor that really values labor rights, I might think that the labor rights of kitchen staff outweigh the sustainability of their food programs because that is what I outweigh over different agricultural policies. People might have a different opinion on that. Or they might be someone that just looks at parts of ESG ratings that focus on risk management rather than just impact. All these different aspects of investing need to be discussed, parsed and brought to light if we are able to make the necessary decisions we want to make in building, let's say, a more sustainable and long-term economy.

And that's it for the week. I wanted to thank Matthew and Namita and Rumi for talking to me about the news with an ESG twist. I want to thank you so much for listening. If you like what you heard, don't forget to rate and review us, and subscribe wherever you get your podcast because that helps us get to you more often for other people to see us. All that is good. Bentley is on next week, so I'll talk to you in a couple weeks. Have a good one.

Speaker 5: The MSCI ESG Research Podcast is provided by MSCI Inc.'s Subsidiary, MSCI ESG Research LLC, a registered investment advisor under the Investment Advisors Act of 1940. And this recording and data mentioned herein has not been submitted to nor received approval from the United States Securities and Exchange Commission or any other regulatory body. The analysis discussed should not be taken as an indication or guarantee of any future performance analysis, forecast, or prediction. The information contained in this recording is not for reproduction in whole or in part without prior written permission from MSCI ESG Research. None of the discussion or analysis put forth on this recording constitutes an offer to buy or sell or promotional recommendation of any security, financial instrument or product or trading strategy. Further, none of the information is intended to constitute investment advice or recommendation to make or refrain from making any kind of investment decision and may not be relied on as such. Information provided here is as is, and the user of the information assumes the entire risk of any use it may make or permit to be made of the information. Thank you.