GREEN VS GREED

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EPISODE 3 - Featuring Isabelle Millat, Head of Sustainable Investment Solutions at Societe Generale

Can the creed of greed feed the need for green deeds? To put it more bluntly, can companies reconcile their thirst for profits with the pressure to have a positive impact on the planet? Or is the current enthusiasm for everything green simply greed in disguise? In this new episode of 2050 Investors, Kokou Agbo-Bloua explores how Environmental, Social and Governance factors, aka ESG, can influence the financial valuation of assets

SOCIETE GENERALE

2050 INVESTORS – EPISODE 3 SCRIPT

(Opening credits for all episode of the podcast)

Welcome to 2050 Investors, the podcast that deciphers economic and market mega-trends to meet tomorrow's challenges.

I'm Kokou Agbo-Bloua, I head up Economics, Cross-Asset and Quant Research at Societe Generale.

In each episode of 2050 Investors, I'll investigate a key mega-trend that relates to the Economy, the Planet, Markets and You.

(Beginning of episode 3)

Warren Buffet once said, "You should be greedy when everyone is fearful and fearful when everyone is greedy".

In trading floor lingo, this means look for opportunities when the market is selling off, ie. when there is blood on the street. That's great but, and to quote a colleague of mine whom I will not name here, "it is best to make sure that it is not your own blood".

This is pretty much the story of June 2021 when the Fed put a break on the reflation story. I guess the Fed was FED up with inflation (pun intended). They said they would raise interest rates sooner than expected. In 2023. Which means they may start tapering QE by the end of this year.

So, shall we take a page out of Warren Buffet's book and say that Greed is good?

Speaking of Greed, everyone wants to be a millionaire. So, here's your chance. I have two questions for you. Ready?

So here we go. Question 1:

- How many trees are cut down each year to print the US currency?
  And the answer is … ZERO, yes ZE-RO. That's because 75% of a dollar bill is made up of cotton rag and the remaining 25% of linen. The greenback is greener than you think!

And now, Question 2:

- Why is the US dollar bill green?
  This is because when it was introduced in its current form in 1929, green ink was relatively more resistant to chemical and physical changes.
  Also, green pigment was available in large quantities for quick printing. Money being green has nothing to do with being green or not.

So, by now you must guessed that today we are investigating: **Green versus Greed.**

Can companies really reconcile their insatiable thirst for profits with the pressure to have a positive impact on the economy, the planet, markets and you? hum… That sounds familiar. I've definitely heard that one before.

Let's face it. A little dose of greed and ambition is what, throughout human history, has often fuelled competition, animal spirits and innovation.

So, to be blunt, can Greed be Green? Or is the current enthusiasm for everything green simply greed in disguise, like a lion pretending to be a vegetarian? And between you and me, the only lion I know who turned vegetarian was Simba in the lion king - hakuna matata.

But I digress…Back to our train of thoughts. What is really at stake here is how do Environmental, Social and Governance factors, aka ESG, influence the valuation of financial assets.

OK. Let's start our investigation and focus on greed to begin with.

If you're a movie fan, I'm sure you remember the 1987 movie "Wall street" where Michael Douglas, as Gordon Gekko, a successful, ambitious, and greedy corporate raider gave a speech where he said "**Greed, for the lack of a better word, is good**". A bit more basic than Warren Buffet.

His argument, although controversial, was to say that greed can be a force that drives action. A force that drives purpose.

Ok, let's stop for a second, I can already hear you thinking:

"But isn't greed one of the seven deadly sins?

Let's be specific and google that for a second. G R E E D … enter … here we go …. Greed is "an inordinate desire to acquire or possess more than one needs, especially with respect to material wealth" ….

Hum… Ok I confess, do I really need to have an iMac, an iPhone 10, an apple watch, and airpods pro? "Let him who is without sin cast the first stone!"

Joke aside. This is not just about a fictional character but human character.

Now let's be academic. The concept of Greed brings the renowned economist and Noble Prize winner Milton Friedman to mind. In 1970, he wrote a famous essay for the New York Times entitled "A Friedman Doctrine: the social responsibility of business is to increase its profits".

He argued that a company has no social responsibility to the public or society. Its only responsibility is to its shareholders. In order words, to maximize profits. By almost all legal means necessary.

This doctrine ushered an era of "shareholder primacy" and was taught in most business schools. A view shared by today's investors and corporate management. But probably NOT by tomorrow's investors, … the 2050 investors!

But Friedman was misunderstood. His point was that if businesses were profitable, their investors could then spend their profits on social goals.

However, this doctrine was challenged over time by the "stakeholder view" which suggests that corporations should take into account the interests of **ALL stakeholders**. That is to say: shareholders, bondholders, workers, suppliers, the environment, society as a whole, governments, regulators etc…

This is starting to sound like a battle between the good and the dark side of the force. "Much to learn you need, young padawan" and don't get me wrong, the padawan here is me!

The Great Financial Crisis of 2008 triggered a change in mindsets with increasing tensions between wall street and main street. This led to more regulation on risk taking. Greed, if left unchecked, could indeed have devastating consequences on all stakeholders.

Fast forward 12 years and the Covid-19 crisis hit. This was the last 'green' straw that broke the camel's back. It triggered a momentous shock wave with a wider adoption of corporate and social responsibility which significantly accelerated the shift into ESG.

To quote Lenin. And yes, I'm quoting Lenin. "There are decades where nothing happens and there are weeks when decades happen".

Inflows into ESG ETFs and green related assets went through the roof. You see that in green bonds, equity sectors, indices, commodities.

- "ESG funds approach 2 trillion dollars as majority of European Flows turn green"– that was a headline in Investment Week in April.
- On CNBC.com in May 2021 another article title read "How the 1 trillion-dollar market for green bonds is changing wall street".
  Clearly, Green bonds are making up a fast-growing part of the 128 trillion-dollar bond market.
- Or as carmignac.fr puts it: "ESG Funds – The new safe haven?"

We now even talk about GREENIUM, … No, this is not a new subatomic particle discovery. It's not the Higgs boson or some new radioactive material like plutonium or vibranium from Wakanda.

It is the premium of green bonds, or of any financial asset linked to climate change and the energy transition.

In the auto sector, electric vehicle pure plays trade at a massive premium vs traditional car manufacturers. You have the same phenomenon, in the energy sector, between renewable pure plays and other traditional fossil fuel energy producers.

So, companies have no choice but to be accountable on E, S and G.

Yannick Ouaknine, Societe Generale's Head of ESG research, was spot on when he said: [Voice from Macro Matters "ESG used to be the cherry on the cake, and now it is the cake"]

The bottom line: Yes, Green is taking over Greed. Investors are being asked to decarbonize their profits. **But what does that actually mean? What are the implications for investors?**

This is something that my colleagues and I frequently discuss with our clients. And of course, amongst ourselves as we strategize on how to best support the ESG transition we are all experiencing.

One of the key factors' investors need to think about is "carbon intensity". Or rather, the carbon intensity of their investment portfolios and the ESG rating of the financial assets they own.

These ESG ratings are increasingly important and have a profound impact on equity and credit valuations of companies.

But wait. Before we look closer at the impact of ESG ratings on a firm's valuation, let's take a minute for a refresher on "how one values a company".

The value of company is equal to the net present value of all of its cash flow into infinity - or at least until it goes bust.

So, for example, let's take the case of a company that makes 100 dollars in earnings and distributes all of it in dividends every year into infinity. It is not worth infinity. That's because, 100 dollars in one years' time is worth less than 100 dollars today. And 100 dollars in 10 years is not worth a lot today.

That's to the beauty of mathematics, you can prove that summing up an infinite set of incrementally smaller numbers is not equal to infinity. It is essentially the sum of a geometric series. It is in fact worth 1000 dollars if the discount rate is 10% and will have a PE multiple of 10x earnings.

So, now let's assume the discount rate goes from 10% to 5%. The same company would then be worth 100 dollars divided by 5% which is 2000 dollars. Or a PE multiple of 20x.

This is the foundation of the capital asset pricing model or CAPM.

So, the discount rate measures risk, uncertainty, the level of future interest rates and the equity risk premium. but it is not an exact science.

It is also the market price of the risk linked to the earnings stream of the company. Its uncertainty, volatility and sustainability.

This is where ESG will and already has a massive impact. Companies with strong ESG credentials trade at a premium with lower a cost of capital or a discounted rate compared to their peers.

OK. Now that we've covered the basics of company valuations, let's take a look at how Environmental, Social and Governance factors influence them.

<u>Let's start with the S of ESG, the Social factor.</u>

Globalisation and outsourcing of capital- and labour-intensive businesses to emerging markets have led companies in developed countries to gradually become asset light and less labour intensive.

Take Apple for example. Apple outsourced the manufacturing of its iPhones to Foxconn in China and kept the high value-added activities such as design and R&D in the US.

The increased use of automation and robots has further decreased the labour intensity of businesses.

Uber does not own any cars. Apple is a 2.2 trillion dollars market cap company with only 100,000 employees. Walmart on the other hand is valued at 390 billion dollars but has 2.2 million employees.

The most valuable companies today are asset light. Not the same as the massive, asset intensive steel or industrial companies of 50 years ago. Business models are evolving and adaptive.

You can think about all of this in this way. Companies are biological organisms. They evolve and adapt their DNA to their competitive environment. They follow a sort of Darwinian process of evolution by natural selection of return on equity.

From dinosaurs with heavy, noisy, rigid, asset intensive business models to more advanced species with globalised and efficient supply chains and automated production processes.

The irony is that some of these asset light companies have good ESG ratings, low carbon footprints but also have fewer employees. Is the equity market telling us that Humans are simply bad for the planet?

That's an Interesting point. The average American is responsible for about 16 tonnes of carbon emissions every year. Globally, the average is 4 tons. And to have the best chance of avoiding a 2% rise in global temperatures, the average global carbon footprint per year needs to drop under 2 tons per person by 2050. Quite a challenge.

But back to the S factor and companies. What's their responsibility towards society and their employees?

I've been keeping the perfect quote up my sleeve for this. Richard Branson, the founder of Virgin group, famously said: "Clients do not come first. Employees come first. If you take care of your employees, they will take care of the clients."

So why is this important you may ask?

Because the single most important factor of success for a team, the factor that drives innovation and creativity is … not money, not greed….

It is the sense of SECURITY, the absence of fear. It is Trust. Because when you are stressed/your reptilian brain generates stress hormones. You are in a fight or flight mode.

You are not going to discover the law of gravity like Isaac Newton did when he was hit by that apple if you are being attacked by a lion – a non-vegetarian one that is.

So decent working conditions and pay are not just important, they are key factors in whether you will succeed or fail in the long term.

So yes, security and being taken care of are necessary conditions for success but they are not sufficient. James Surrowiecki, in his book "Wisdom of the Crowd", brings another brilliant perspective.

He states that a group of people can be smarter than the smartest person in the group if three conditions are met.

Condition one: you need a minimum level of IQ. And I guess that if you are STILL listening to this podcast, then you have nothing to worry about.

Condition two: independence of views and thought - thinking for yourself basically.

And finally, diversity of diversity. This includes academic background, professional experiences, age, gender, ethnicity, and so on.

The bottom-line message here is: the social or the S of ESG is better than greed when it comes to creating sustainable value.

OK. So now we covered the S of ESG. Now let's talk about the E and G or <u>Environment and Governance. And as you'd imagine, the risks are pretty much self-explanatory.</u>

Take the devastating impact of the Deepwater Horizon oil spill in April 2010 in the Gulf of Mexico. It led to 11 fatalities and 4.9 million barrels of crude oil into the Gulf.

Or the long list of corporate frauds linked to poor governance. A quick google search on the biggest business scandals of 2020 leads straight to Wirecard's collapse. A German payment processing company that became the largest European accounting fraud case of last year. It had inflated its balance sheet by 2.3 billion dollars.

So clearly, Environmental, Social and Governance factors can make a huge difference when it comes to making investment decisions, when it comes to assessing investment risks.

We can even talk of a Green Efficient frontier – where investors can lower their risks more than they sacrifice returns. Investors may even improve returns as green projects can also be profitable. Therefore, GREEN IS BETTER THAN GREED AT MAKING GREEN. (double pun intended).

They key point though is in improving the impact of known unknowns – we talked about this already in our previous episode.

Let's bring in Isabelle Millat, Societe Generale's Head of Sustainability Solutions, for her take on all this.

[Interview starts]

Kokou: Hello Isabelle.

Isabelle: Hi Kokou.

Kokou: I know you are a green guru when it comes to sustainability solutions. I have a question for you. What can investors do in practice to get exposure to ESG related investment?

Isabelle: Well, first, maybe I'd say with the team, we are enablers rather than gurus. We're here to help turn incantation into action. And to do that, actually, there are three questions to investors. Why, where? And then we can turn to the how. So why do they want ESG? Do they want their investments to align with some environmental or social beliefs? Do they want to benefit from business opportunities resulting from environmental and social trends? Of course, they want to do both. The question is, which comes first. Then the where? Well, once you know why, you need to know if your client is targeting a short-term liquid bucket of investment or maybe a longer term one, it's not the same thing. Also, if they want capital protection or yield. So really, why and where are important. But having said that, what can they do? The how. What solutions do we have for them? ESG is everywhere and solutions are multifaceted. But I know you're a busy man, so let me just illustrate with one theme, which is climate investing. Well, first, investors can do certificates on baskets that's popular with private banks. And you can create a thematic basket of stocks of companies and sectors that support the climate transition.

So thematic baskets are one. But some portfolio managers actually need sector diversification, so they could invest across industries, but only in those companies which are reducing their carbon emissions most rapidly. And again, if you create that basket, what's nice is it's versatile. You can trade it in multiple products like listed trackers or even more bespoke bank solutions. Then of course, for more targeted impacts. Investors can buy positive impacts or green bonds where issuers commit to EMR proceeds towards some audited green projects. You need to know why you want to go ESG. In other words, you need to position your investment on the triple bottom line of sustainable investing, which is People Planet and Profit. Those of us who studied business will remember the four P's promoted by Philip Cutler to define a marketing mix. Well, actually, sustainable investing has its three P's. Also, again, People Planet, Profit.

Kokou: This is amazing. There's a huge variety of solutions, but the risk of green washing is real. How do you build trust with them in the long run?

Isabelle: Yes, indeed. All that glitters isn't green. And the risk of portraying as green a product that really isn't exist. But because we want to grow sustainable investing in a sustainable manner, we are very cautious and disciplined with processes and controls for our solutions. Trust is built with time and transparency, so we make the time to understand investors goals. And then we transparently lay out the features of each of our solutions and you know what they say trust but verify. So, for example, when an issuer commits to EMR the proceeds of a positive impact bond towards sustainable and positive impact projects. There should be an audit and a report to investors on these projects. So, you can look at it this way. There's a double promise in ESG values and value. The question is what value do investors assign to values? Should there be a trade-off and if there is, which one do they prioritize? Then of course I would conclude by saying we always attempt to combine both and deliver values and values in all solutions.

Kokou: Thanks, Isabelle. I think the main takeaway here can be that the value of values might be more important than the value of returns up to a certain point, but this is probably a topic for another podcast.

[Interview ends]

So, to wrap up, the Green vs Greed debate might simply be about our collective conscience, which as it happens was nicely summed up by Michael Jackson. I realize that there is a lot controversy about him, but he was pretty spot-on when he said: “Heal the world, make it a better place for you and for me and the entire human race.”

Even Dante in the Divine Comedy “Inferno” wrote “The hottest places in hell are reserved for those who in time of moral crisis preserve their neutrality.”

We all have a role to play. And remember, as the Rock said: “it is nice to be important, but it is more important to be nice”

(Credits)

Thank you for listening to this episode of 2050 Investors and thanks to [Isabelle Millat] for sharing some useful insights with us.

I hope this episode has helped you get a better glimpse of the future of finance! You can find the show on your regular streaming apps. Please subscribe, leave some stars on Apple Podcasts, leave comments anywhere you like and spread the word!

See you at the next episode!

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