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TRANSCRIPT

Medicine, Chocolate and the ESG data-verse

Featuring:

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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 affect and are affected by our economy. I'm Bentley Kaplan, your host for this episode. On this episode, we are going to take you into the ESG data universe. We're doing this, shoving our dear listeners into the wonky, geeky side of ESG because frankly, it is long overdue. As headlines continue to pile up, sometimes earnest, sometimes misleading. It became clear to us at MSCI ESG Research that we had to take back some of the narrative. Mostly just to clarify what ESG is, what it isn't? Why answering a question like, is that a good ESG company, is never going to be a straightforward exercise. On today's show, we're going to tackle a misconception that we see very often. The idea that ESG is all about measuring the positive or negative impact that a company generates. Linked to that the idea that a company with a high ESG rating is also one that makes the world a better place.

To shatter that misconception, we are going to use two examples. Johnson & Johnson and Nestle. Two massive global companies that you would definitely have heard of. But also ones that probably made their way into your day, your week, your month, and yes, even your year. As we get up close and personal with these companies, keep in mind one question that will unlock the whole episode for you. Is this about what happens to the company or is this about what happens because of the company? Scribble it down on a piece of paper, if you've got one handy. In the meantime, thanks for sticking around. Let's do this.

Now, this episode builds on two that came just before it. The first was called, Everyone Hates ESG. In it, my co-host, Mike Disabato and Meggin Eastman introduced the idea of ESG investing and especially how to understand different types of ESG assessments and the underlying data. The second was called, The Enigma of Tesla's ESG. In it, Yu Ishihara walked me through a 360-degree view of the world's coolest electric vehicle manufacturer. If you want to get deeper into this topic, I would highly recommend adding both of these episodes to your playlist. But to get you up to speed, here are the crib notes. To navigate this exploding universe of ESG data, the most helpful thing you can do is to focus on what questions you are trying to answer. We found it was helpful to look at those potential questions in four clusters. The first two are the ones we are going to look at today.

One is financial materiality. In basic terms, how ESG factors could make things more costly for a company or squeeze their profits. Two, social or environmental impact or what a company's operations products or services means for the people and environment around it. We also looked at two more. They are climate risk or what impacts a company might face because of the direct and indirect consequences of climate change and climate impact, or what a company's operations products and supply chains mean for climate change. It's contribution to greenhouse gas emissions. But we're going to park those two for a future episode and that pretty much brings you up to speed. Let's get back to the here and the now. In the here and the now, my two young kids are basking in the afterglow of their very first Halloween trick or treating. Now, it's not really a traditional holiday in South Africa, but it turns out that kids don't really need a solid narrative arc to be convinced about the merits of walking the streets at night, collecting more sugar than they can carry.

As parents trailed behind their marauding children, I was struck by how normal things felt. Suddenly, how long ago COVID 19 lockdowns seemed to be. I had the sudden twinge of gratitude to all the people and companies that helped to move us through this unprecedented time. That included some of the world's biggest healthcare companies like Johnson & Johnson. Johnson & Johnson is a big healthcare company that made $95 billion in revenue and not just from selling vaccines. J&J is into everything from band aids to baby shampoo, Tylenol, orthopedic and surgery products, and even treatments for some of the world's most famous and awful diseases like HIV, tuberculosis, and Ebola. Even though all of these products seem very different, there is a thread that ties all of them together. As my colleague, Julia Giguere-Morello tells it, healthcare is a unique industry, which means companies have to respond to very specific pressures and opportunities.

Julia Giguere-Morello:

J &J like other healthcare companies are in this really very special, sensitive, social license to operate, extremely high-stake sphere because we're talking about people's healthcare. J&J and other healthcare companies are really tasked with bringing to market, hopefully but not always, innovative care and treatments. All while minimizing adverse side effects and risks. Not only does J&J need to conduct really extensive RND, and identify something that works or perhaps even treat something, they need to figure out how it is absorbed, how it is distributed, metabolized, excreted in a human body. Then, they need to scale it, source a key ingredient in bulk, manufacture it at scale, launch it, figure out the distribution channel, and the list goes on and on and on. But before it even gets into the hands of a patient, regulatory agencies are really critically weighing, do the medical benefits outweigh any potential risks?

Bentley Kaplan:

In this industry that touches on the health and wellbeing of so many with this intense regulatory scrutiny, the immediate question that pulled me in was, okay, well this is a healthcare company and that seems like a smart bet. It makes sick people better. Band-Aids, I mean, they're so ubiquitous, they've given rise to their own expression, which may actually be doing them a disservice. But let's set that aside for now. J&J's vaccines together with those of their peers have ultimately led to my kids being able to run riot on Halloween and shoving fistfuls of candy into their well-washed faces. But remember, the reason we wanted to look at J&J in the first place was to untangle two topics that are often conflated, specifically how ESG factors affect the company and create financial risk. Then, what ESG factors are affected by the company by its external impact? First up, here's Julia to explain how ESG can translate into financial downsides or even upsides for J&J.

Julia Giguere-Morello:

The potentially financially relevant ESG risks and opportunities are really most importantly, if we haven't already guessed by now, patient and product safety and secondly, access to healthcare. Here, we have this very interesting trade off, which is one of the reasons why J&J has a solid ESG rating of A, but also does not rank at the relative top of its peer set. Since it's an A, it's not a AA or AAA. On access to healthcare, J&J has a large proportion of its RND and its product portfolio geared toward diseases that disproportionately place a burden on global health. We talked about HIV most notably, but also tuberculosis, oncology, equitable pricing based on affordability. On the product safety side, J&J does have fairly robust quality policies and standards. I think this is something that we would really expect from the pharmaceutical industry.

The industry is highly regulated. Yet, what is really weighing it down is allegations related to the improper marketing of some select products. This includes one of its antipsychotic medicines. It also includes allegations related to misleading sales and marketing of opioids, which it no longer makes, but it is suddenly claims here in the area of multiple billions and this is substantial. J&J is also facing allegations related to cancer risks on its talcum-based baby powder.

Bentley Kaplan:

Right. As Julia diplomatically points out, as a company, you really don't want to have words like baby and safety risk, or even worse cancer in a headline referring to your products. Because in the stark lens of financially relevant ESG of what ESG means for the company itself, this means things like fines or regulatory interventions or consumers shutting your products. On the day I'm recording this, like Johnson & Johnson before them, CVS and Walgreens have agreed to pay a combined $10 billion over the sale of opioids. But it's not all downside, because Johnson & Johnson can see financial upsides from investing in equitable access for healthcare in underserved populations. All of that is really about what ESG means for a company. But for some when they think about ESG, what they're actually thinking about isn't what it means for a company's bottom line, rather what a company means for the world around it. How the company creates positive or negative impacts?

To answer questions about a company's impact, we need very different data than things like risk management or factors that are linked to profit margins. Instead, we are looking for measurable impacts outside of a company. Things like better access to clean drinking water, improved access to education or the restoration of degraded forests. These impacts can be measured with different frameworks. One that we work with at MSCI is the UN's Sustainable Development Goals. If you're not familiar, there are 17 of them. Their scope and ambition is impressive. Even working towards these targets without reaching every single one of them, would arguably stave off some of the most severe social and environmental consequences that we seem to be flirting with.

In our approach to assessing a company's impact, we look at how well aligned it is with these 17 SDGs. Both by virtue of its revenue, so what types of products and services it's selling, but also through its operations and activities. An impact or alignment in this case can be seen both ways. Either, positively aligned with getting the planet closer to a specific goal or negatively aligned by pushing us further away from a specific goal. Here's Julia, to give us an idea of where Johnson & Johnson would fit into this type of impact driven framework.

Julia Giguere-Morello:

Surprisingly, if we were to just guess which goals J&J would be aligned with, we would guess maybe Sustainable Development Goal number three, which is good health and wellbeing. It is a healthcare company. But overall, J&J's net alignment here is in fact neutral. This is because yes, J&J is strongly aligned in terms of providing solutions and products to address major diseases across the world. Yet due to its safety allegations and controversies from an operational standpoint, on a net basis, this leads to a neutral alignment.

Bentley Kaplan:

For Johnson & Johnson, its products do generate positive social impact. Good medicine is a good thing. It also means that for investors that are interested in supporting Sustainable Development Goal number three, which is about good health and wellbeing, well, healthcare companies are going to be natural candidates. But as Julia tells it, what you make can matter as much as how you make it or how you sell it. For all of J&J's great vaccines and support of better healthcare in emerging economies, it's also the same company that was accused of mis-selling opioids and for improper marketing of antipsychotic medication. There is no single way to balance these positive or negative impacts against one another. There's no one way to calculate how many vaccines in emerging countries would offset something like the aggressive marketing of opioids. Just like there is no single way to measure the financial risk that Johnson & Johnson faces from ESG related factors. The current evolution in the ESG investment space is about clarifying what we're trying to measure in the first place, and being clear that a company like J&J is different things to different people.

Now, thanks to Johnson & Johnson, my kids managed to hit the Halloween streets in a post COVID world. But it was partly thanks to another company, Nestle, that they managed to get such a hefty hold of sweets and chocolate. Like Johnson & Johnson, if you're a consumer thinking about Nestle, it's not unreasonable to feel a little bit torn about the company. Sure, they make some of my favorite foods, but at the same time also it sticks in my mind because of disputes over the sources of its bottled water. According to Cole Martin, who covers consumer staples for us, it's not only consumers that feel this confusion or conflict, but investors too.

Cole Martin:

One thing you often see in the media is confusion about how companies perform on different aspects of ESG. You'll hear commentators say something like, "Wait a minute, this company has been involved in all sorts of, I don't know, false advertising or pollution lawsuits." They've been the targets of NGO activism or what have you. Yet somehow, they have a pretty high ESG rating. How is that possible? Things can get overwhelming pretty quickly if you're not careful. You can often have a situation where a company may have best practices in place to manage its environmental risks. But when it comes to social issues, they're willfully unprepared or even vice versa. Even that they have good policies in these particular domains, but then they're involved in all of these news articles or NGO publications because they're apparently clearing away protected forests or bribing government officials or other things like that. When it comes to these sorts of contradictions or things that don't always make immediate sense when you view them side by side, Nestle can be a very interesting example of how this could happen.

Bentley Kaplan:

Cole is promising a couple of contradictory angles right off the bat. He has that lovable upfront type of style. He's going to work through Nestle by asking about the differences between ESG factors that happen to the company, its financial risk, and what external impacts happen because of the company. In the same way that Johnson & Johnson has this giant presence in the world, so too does Nestle. The company has nearly 300,000 employees, 2000 separate brands, and in 2021 sold more than $5 billion worth of chocolate. Based on what my kids unleashed on Halloween, you can expect a little upward nudge of that number in 2022. Although, something like product safety is definitely a risk for a food company, it's working with a little less regulatory oversight than a healthcare company like J&J. In our assessment of Nestle's financial risk, our ESG rating, the company does well. Rated as AA just one notch below the best possible of AAA. For Cole, understanding the signal comes from a systematic assessment of the company's practices rather than resting too much on newspaper headlines.

Cole Martin:

Look, I think all your listeners know that Nestle is a huge company. They do lots of different products in lots of different countries. And so, we look at things like, it's supply chain, the products it makes, what goes into them, the byproducts of that production, and then ultimately that data goes into different ESG products. If we look at Nestle at more depth, we can see that it scores pretty well on how it manages financial risks linked to environmental factors. Things like its carbon emissions or dependence on water. Intuitively, if you know Nestle only from headlines, that may not immediately land for you. But what we're actually doing is assessing how well they manage their risks by looking at things like the company policies. Just to give you a practical example, Nestle has a net zero target, which very few other food companies have, and its emission reduction plan is supported by the Science Based Targets initiative, which is also relatively rare within the industry. To the extent that our overall ESG rating is based on environmental metrics, chances are the company is going to score pretty well.

Bentley Kaplan:

Okay. As Cole tells it, Nestle has some industry leading practices, which lets it stand out amongst competitors. Scoring well above them on our overall assessment on how it manages environmental risks. But with enough in both our assessment of its social and governance practices to land it into the leader category and a letter rating that sits against a pleasing dark green background. But there are those that might bristle at the thought of Nestle receiving such a rosy assessment. That's probably because the term ESG means something different to them. Not whether specific ESG factors create financial risks, instead thinking of ESG in the terms of external impacts. Like Julia showed with J&J, Cole took me through how he thinks about Nestle's impact through our SDG alignment framework, which tells a very different story to a AA ESG rating.

Cole Martin:

Now, where Nestle doesn't score so well is when we look at the company's impacts, particularly in the social dimensions. One way, we get to this is by looking at the 17 Sustainable Development Goals or SDGs, which were adopted by the UN in 2016. Now, one of the reasons why we find a big gap between what the SDGs are looking to achieve and where Nestle currently is, has a lot to do with chocolate or cocoa to be more specific.

One of the reasons why they don't score that well in the SDGs is because some of the metrics within the SDGs essentially punish companies that have child labor in their supply chain. Nestle has a couple of severe controversies related to child labor in West Africa. Now, Nestle might argue that the impact the child labor allegations have on Nestle's SDG alignment is probably a bit unfair on the company. I do think it's fair to argue that the child labor issue in West African chocolate isn't a Nestle problem per se. It's an endemic problem across the industry that affects many companies operating out there. In fact, Nestle's program to eradicate it may well be the most aggressive in the industry.

Bentley Kaplan:

For Nestle, admittedly, it is operating in an industry that has very systemic challenges. One of them being the use of child labor in cocoa plantations in West Africa. As an analyst, who looks at ESG ratings also, Cole can appreciate the strength of the company's efforts to rectify these issues and what Nestle's competitors are doing by comparison. But looking at these outcomes from an impact perspective, will the strength of the company's risk mitigation programs take a much lower priority? In many ways, holding multiple ESG lenses up to the same company simultaneously can feel a little bit like cognitive dissonance. Agreeing to disagree with yourself. But getting through that confusion as we found with J&J is all about making sure you're asking the right question to get to your end point, wherever that may be.

Cole Martin:

I think if you look overall, Nestle is an interesting case study because: A. There's quite a big contrast in how the company manages its environmental versus its social risk and impact. B. It's an extremely large consumer facing company, that in theory impacts the lives of hundreds of millions of people every day. What can happen is this can make the company a target of media or consumer scrutiny. In fact, you saw that during the first ages of the Russia-Ukraine war, where there was a considerable backlash against the company remaining in Russia from both consumers and even the media to an extent. If all you did was look at the company's ESG rating, I think it would be hard to capture the subtleties of all these different issues the company is facing. Instead, by looking at the company through various different lenses, whether it's the rating, environmental specific tools, or social specific tools like the SDGs, investors can get a much more nuanced look at Nestle and help them cut through the noise in the marketplace.

Bentley Kaplan:

In our previous episode, we focused on Tesla and the company is often in the headlines, which can make it a fun and interesting company to analyze. But for all the progress that the company has made towards electric vehicle uptake, it remains a pretty niche product. Maybe, you know someone who knows someone that drives one. Maybe, you drive one and you're busy letting autopilot take care of the details while you're listening to the show. But it's not all that likely. By contrast, the companies that we've covered today are almost diametrically opposed to Tesla. They're large and established with brands recognized across many markets and products used or consumed by hundreds of millions of people. The externalities of companies of these size are considerable, both in terms of negative impacts like child labor in West African cocoa or opioid mis-selling, but also in positive impacts like vaccine production.

For impact investors, it makes sense to look at these companies through that lens, to figure out what each company means by how it would affect people or the environment. But not all of these impacts or outcomes ripple through in the same way for financial risk, which is reflected through a different signal. For us at MSCI, that is the company's ESG rating. For investors looking at this signal, how the company affects the world around it is a consideration. But only rarely in the way that it could blow back on the company itself. Well justified outrage over the use of child labor in cocoa production does not necessarily equate to financial risks for a company that uses cocoa in its products. But that bridge between these very different aspects of ESG can and does close, especially where regulations evolve to address these differences.

Johnson & Johnson and its healthcare competitors are a great example of where something like product safety issues don't only result in negative impacts for patients, but for the company too, through fines, regulatory pressure, or a loss of consumer trust. I hope that teasing apart this idea of financial risk with external impacts has given you some metaphorical food for thought. Because for now, I have to get some actual food into my kids to try and dilute some of that Halloween sugar.

And that is it for the week. A massive thanks to Julia and Cole for their take on the news with an ESG twist. Thank you very much for tuning in. I know that some of you are still pining for Mike, but don't. He's doing well and taking the pace of life a little differently without a weekly podcast cycle. The best way to reach him is to give the show some stars on iTunes or Spotify or Stitcher. I know what will make him really happy is if you hit that subscribe button to make sure you don't have the hassle of trying to find the show every week. Just let it come to you automatically and save your mental capacity for something more useful, like Sudoku or the Wordle, if that is still a thing. But for now, take care of yourselves. I'll be back again with you next week.

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