ALTERNATIVES

Understanding the Climate Change Challenges Facing Consumer Goods Companies

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As an active investment manager with a firm commitment to integrating environmental, social and governance analysis into its investment processes, Franklin Templeton recognizes its responsibility to raise awareness of climate transition issues. Working alongside the Carbon Disclosure Project, Franklin Templeton recently co-hosted a roundtable event on consumer goods companies' preparations for the low-carbon transition. Here, Julie Moret, Head of ESG at Franklin Templeton, reports back from the event.

Amid all the analysis of the recent European parliamentary elections, the strong support for the Green Party was an underappreciated development.

We think the Green Party's success—it secured 69 seats and is the fourth-largest party in the parliament—is likely to bring further momentum to climate-focused initiatives and policy directions already underway in Europe and across the globe.

As active investment managers, we have a responsibility to understand the implications that these political and societal shifts mean in terms of risks and opportunities for our portfolios.

But equally important, we have a central role in raising awareness of climate transition issues, not only within the investment management industry and among our peers, but with corporates through our engagement activities to ensure the resiliency of the companies and issuers that we invest in.

As part of that responsibility, we play an active role participating in industry events and supporting initiatives. We recently hosted an investor roundtable on behalf of the Carbon Disclosure Project (CDP).

Investors, asset managers and bond issuers attended the event, which included speakers from Franklin Templeton as well as Heineken, the Ellen MacArthur Trust and the CDP, which unveiled its latest report: *Fast Moving Consumers: Which Consumer Goods Companies Are Ready for the Low-Carbon Transition?*

Why Look at Consumer Goods Companies?

In general, carbon-emissions intensity profiles of consumer goods companies are comparatively low, but, as we learned, this is a sector that plays an important role in the broader area of climate change.

Analysis of its value chain—in other words, those businesses with which consumer goods companies interact to manufacture, transport and distribute their products—paints a different picture.

According to the CDP report, when the value chain is taken into account, the consumer goods sector accounts for nearly a third of global emissions.[1] Much of that stems from the role food and agriculture play in providing the raw materials for consumer goods.

Food and agriculture account for around a quarter of global emissions, the report notes. And that fact should be a central consideration for investors, according to the CDP.

The physical risks of climate change, such as risks associated with heat and water stress, have the potential to disrupt the supply of agricultural commodities. As a result, we're likely to see continued resource constraints and price volatility around the raw commodities that these companies rely on.

Water Stress Under Scrutiny

For example, water stress has the potential particularly to disrupt household and personal care companies, not just in the production, but also in the consumption phase.

The products that these companies produce—laundry and bathroom products, for example—are water-intensive at the usage phase, so if their selling markets are likely to be affected by water stress in the future, it could significantly impact the feasibility of those companies.

Crucially, as the CDP highlighted, many of the regions in which water stress is an issue, such as India and China, are also areas in which these companies are relying on high-growth rates.

Our Head of European Fixed Income, David Zahn, explained during the session that water stress is one of the material factors Franklin Templeton's research analysts scrutinize.

"We know access to fresh water varies dramatically across the world. Areas that are wet are getting wetter, areas that are dry are getting drier," Zahn said. "As investors, we want to make sure that our portfolios would not be stressed by a global drought or by flooding."

Our analysis suggests companies are starting to consider water usage, but again we're not seeing a consistent approach.

"Our general experience is that investment-grade companies are looking at this topic, while high-yield companies (those with lower credit ratings) are generally less concerned with this topic and tend to focus more on making short-term profits," Zahn explained.

"Growing awareness of water usage presents a real opportunity. Once companies see that engaging and addressing this issue could make them more money and improve their attractiveness for investors, it's a real win for everybody."

The Role of Public Opinion in Shaping Decisions

Zahn went on to highlight the importance of consumers in changing corporate behavior.

He said: "A lot of decisions taken in the board room are driven by customer behavior. Companies want to make money, but their decisions are driven by their end-consumer."

And as Zahn explained, it's not just corporate behavior that is influenced by public opinion, government policy generally adapts to reflect changing sentiment.

"After the Green Party's success in the European parliamentary elections, we'd expect to see its environmental agenda come through strongly in the forthcoming parliamentary sessions. For example, we expect a legislative force on reducing carbon emissions and water usage."

The CDP report also highlighted evidence of shifting consumer preferences; for example, shoppers are demanding more natural, chemical-free and plant-based products and reduced packaging footprints.

The Investment Opportunity

Our own analysis echoes the finding of the CDP report: there are a handful of companies that are leading the way in innovation and risk management around sustainability.

However, we recognize there's a lack of consistency as well as data disclosure and certain vulnerabilities remain.

As investors, we're not necessarily looking for best-in-class examples of environmental, social and governance (ESG) practice, but rather we want to see a practical desire to drive improvement.

It's the rate of change towards a sustainability agenda that we care about the most. When the rate of change starts to pick up, that's usually a sign management has become engaged. That's when we see a solid investment case.

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What Are the Risks?

All investments involve risks, including potential loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

Actively managed strategies could experience losses if the investment manager's judgment about markets, interest rates or the attractiveness, relative values, liquidity or potential appreciation of particular investments made for a portfolio, proves to be incorrect. There can be no guarantee that an investment manager's investment techniques or decisions will produce the desired results.

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1. Source: Carbon Disclosure Project, "*Fast Moving Consumers: Which Consumer Goods Companies are Ready for the Low-Carbon Transition?"* June 2019.