PERSPECTIVES

PODCAST: How a Broadening Stakeholder Base Shines a Light on Sustainability

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Around the world, societal demographic shifts are becoming evident, bringing long-standing assumptions and theses into question. Julie Moret, Head of ESG at Franklin Templeton, explains why investors should consider how companies are managing and navigating some of these broader drivers of change.

Listen to our "Talking Markets" podcast for more from Moret.

We're living in an increasingly changing world. The global population is estimated to hit 10 billion by 2050.[1] Around 2.5 billion more people will be living in cities by 2050, with urban areas representing 68% of the world's population.[2]

Alongside this, we're facing rising CO_2 emissions, as well as increased air, water and soil pollution.

Against this background, our experience suggests investor preferences are changing too. A recent study we carried out in the United Kingdom echoes the findings from other global research, showing the millennial generation—those born between 1981 and 1997—is actively seeking investment capabilities that deliver a positive environmental and social outcome, alongside producing attractive financial returns.

Demographics shifts and environmental headwinds sit very clearly under the environmental and social banner, but we also consider them to be economic issues. They are potential drivers of change that can impact the operational resiliency of businesses over the medium to long term. We believe this makes demographic and environment considerations relevant for any active investor to understand from a risk-and-return lens.

Megatrends, Sustainability and ESG

Megatrends stemming from these economic drivers are reshaping our world and altering how we operate as consumers and investors.

As a result, companies have to think differently to adapt and sustain their business models. Many businesses are looking to tap into technological advancements to maintain operational efficiencies and continue to generate sustainable growth and earnings.

For example, global population growth and urbanization are driving up demand for energy, food and water. Estimates suggest global energy usage and food production will grow 50% by 2030, with water usage up 30% over the same time period.[3]

That expected increased demand presents complex challenges to companies competing on a global scale for finite resources. In response, we're seeing a growing focus on the efficient use of resources. That includes rethinking waste management, which we believe could benefit companies providing circular economy solutions.

We believe sustainability is at the heart of understanding the consequences and opportunities of this evolution of thinking.

We define sustainability as taking an objective view on how society, consumers and investors are behaving differently and how customers are managing these drivers of change. Considerations of sustainability should focus minds on vulnerabilities and future potential drivers of growth.

In our view, a strong corporate governance foundation sets out how a company is governed and managed. A well-governed company typically also demonstrates strong management of its environmental and social impact, including its human capital.

Environmental, social and governance (ESG) analysis and metrics can offer a measure of sustainability as well as an indication of how companies are approaching longer-term strategic risks.

A Growing Focus on a Wider Stakeholder Base

All of these components highlight the increasing pressure that companies are facing as they manage a wider pool of stakeholders beyond shareholders concerned only with profit maximization.

Companies need to consider carefully how they handle broader stakeholder relationships, including those with consumers, employees, suppliers and local communities. These relationships ultimately govern a company's social license to operate.

In an increasingly global supply chain, there's more focus on the treatment of suppliers, particularly in emerging economies where weak governance and management can lead to value destruction, either in the form of reputational risk or regulatory fines.

This shifting focus to encompass a wider group of stakeholders is becoming more apparent to us.

The UK Stewardship Code most recently broadened its definition of stewardship to encompass the economy, environment and society.

Its new definition reads: ''Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.''

Also, in August of this year, the Business Roundtable, an influential group of 181 CEOs in the United States, announced a new statement redefining the corporate purpose to meet the needs of all stakeholders.

An ESG Toolbox to Better Understand Intangible Assets

In this evolving environment, our analysis shows that intangible assets, including reputation, brand loyalty and intellectual capital, have formed a larger proportion of companies' valuations over time.

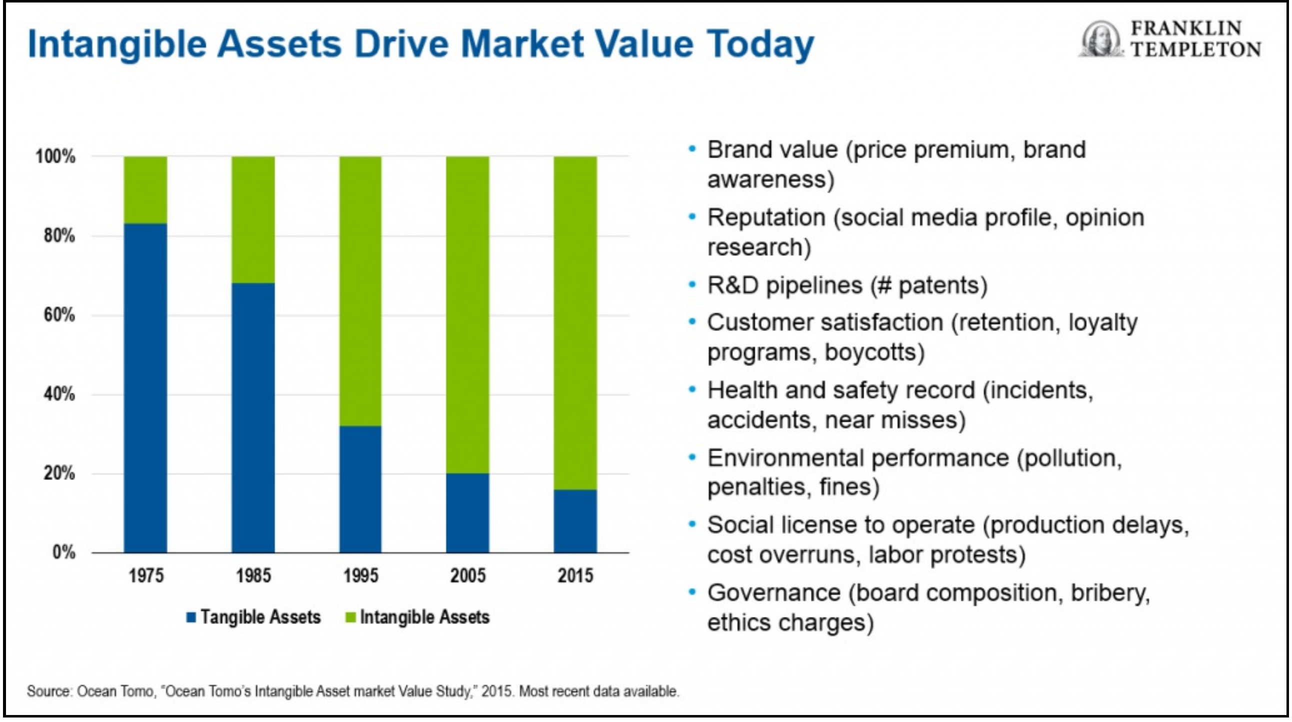
According to a report from intellectual property valuation firm Ocean Tomo, intangible assets accounted for more than 80% of the market value of the S&P 500 Index in 2015, up from 17% in 1975.[4]

Intangible assets are drivers of corporate valuations that balance sheets or accounting metrics don't necessarily capture. However, they are becoming more important in understanding intrinsic value.

We believe financially relevant ESG information can provide better insight into how companies manage many of these issues.

We think there are questions around whether today's valuation models, which are calibrated for asset-heavy companies, currently capture some of the latent risks around intangibles.

We believe there's a strong argument that ESG information can be helpful alongside traditional company financial analysis in providing a more holistic view of long-term intrinsic value.



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1. Source: United Nations, "*World Population Prospects 2019,*" August 2019.

2. Source: United Nations, "2018 Revision of World Urbanization Prospects," May 2018.

3. Sources: HM Treasury, Food and Agriculture Organization of the United Nations, International Energy Agency, International Food Policy Research Institute, BofA Merrill Lynch Global Research. There is no assurance that any projection, estimate or forecast will be realized.

4. Source: Ocean Tomo, "Intangible Asset Market Value Study," 2015. The S&P 500 Index tracks the stocks of 500 large-capitalization US companies. Indexes are unmanaged, and one cannot directly invest in them. They do not include any fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.