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What we measure affects what we do

Part I

Franklin Templeton and Green Templeton College, University of Oxford, recently launched a three-part series of virtual academic sessions and investor panels focusing on "The Way Forward: Navigating the COVID Challenge." Academics from Green Templeton College have shared their latest research with Franklin Templeton investment professionals, with the hope of delivering actionable insights. The final installment of the three-part series featured three components. First up, the lecture "Building Back Better—But on What Foundations?" by Nobel prize economist and Columbia University Professor Joseph E. Stiglitz, which is summarized in Part I of this piece. Following the lecture, Stephen Dover, chief market strategist and head of Franklin Templeton Investment Institute, interviewed Professor Stiglitz. Highlights of that interview follow in Part II. Part III of this piece features a panel of experts discussing the key themes and topics explored in the series; Franklin Templeton Investment Institute provides a summary of the panel discussion.

Key takeaways from the lecture

- Gross domestic product (GDP) growth is not by itself a sufficient economic metric to make policy nor investment decisions. Professor Stiglitz argues governments and investors should use a dashboard of broad economic measures to make policy and guide investments. The dashboard should include measurements of social and environmental factors. Since what we measure affects what we do, and if we measure broader factors such as income inequality or environmental impact, it is more likely that we will have policies that address those issues. GDP alone is too broad a measure and does not provide sufficient data about the makeup of the economy. If we measure the wrong factors, we may implement poor policy in terms of planning for broad and inclusive economic strength and sustainability.
- Low levels of inflation in the 2%–3% range could be positive for the economy and for economic equality. There is excess supply globally. Most of the world has neither the fiscal space nor the resolve to spend as much money as the United States to recover from COVID-19. Emerging markets (EM) are spending a fraction of that amount, and some of those economies have been hit much harder by the pandemic. Professor Stiglitz argues that a slightly overheated economy may be positive, because when we have a very tight labor market there is likely to be wage compression (when incomes at the bottom increase relative to those at the top). He states this gives marginalized groups a better chance of getting into the labor force. Thus a tight labor market will be good for our economy in terms of reducing economic inequality.

Better metrics

GDP by itself is not a sufficient measure of overall societal well-being, sustainability and economic resilience. Let's take COVID-19 as an example. Many parts of the world, including the United States, were inadequately prepared to manage the crisis. This was in part because of a lack of understanding of the risks we faced. We did not measure the right things to ensure holistic economic strength.

We need better metrics. What we measure affects what we do. If we measure the wrong things, we will do the wrong things in terms of planning for future strength and sustainability.

In the United States, the current administration talks about building back better. How do we assess whether we are successful in doing so? A single number, like GDP, does not capture the complexity of the multiple objectives we need to achieve. We cannot just focus on material strength, we need to consider other factors like environmental degradation, social equality and healthcare. We need a dashboard of metrics to monitor and assess.

Take, for example, environmental concerns. Are we on target to reduce emissions? We can measure the trajectories needed to reach carbon goals and assess the economic costs of not doing so.

Similarly, in healthcare we can look at things like mortality rates, for example. Data such as this may be more useful versus trying to measure these issues in dollar equivalents. One of the reasons why the United States was so vulnerable to COVID-19 was the large level of healthcare inequality. If we have data to assess these disparities, we can better prepare for future uncertainty.

Professor Stiglitz is not worried about inflation in the long term. There is excess supply globally. Most of the world has neither the fiscal space nor the resolve to spend as much money as the United States to recover from COVID-19.

Metrics on poverty play a very important role in assessing economic strength as well. The forecast made by some at Columbia University is that the Biden administration's proposed US$1.9 trillion rescue package will reduce childhood poverty in the United States by approximately 50%. In a country where 20% of children have lived in poverty, this would be a tremendous achievement.[1] If large fractions of a population are growing up in poverty with poor healthcare and lack of access to adequate education, this does not bode well for the future growth and prosperity of the country. These are things that can be better captured in metrics beyond what we focus on right now.

Modest inflation may be good for the economy

Professor Stiglitz is not worried about inflation in the long term. There is excess supply globally. Most of the world has neither the fiscal space nor the resolve to spend as much money as the United States to recover from COVID-19. EMs are spending a fraction of the amount, and some of those economies have been hit much harder by the pandemic. Yes, we are seeing some supply bottlenecks in particular areas, but that is to be expected when you are emerging from a 12-month shutdown.

When interest rates are at or near zero capital is "mispriced." This could lead to poor investment or economic decisions. If we have a little bit of an increase in inflation, and interest rates rise, then we will have a better indication of the price of capital and ideally could make better decisions. We have tools to dampen inflation if it gets too high, and we can monitor the economy better than we could in the past. Indeed, a slightly overheated economy may be welcome. When we have a very tight labor market, where there is wage compression with incomes at the bottom increasing relative to those at the top, we succeed in getting marginalized groups into the labor force. A tight labor market will be good for our economy in terms of reducing inequality. In this way we will have a much more inclusive and sustainable recovery.

1. In the last decade, the US child poverty rate peaked at 22% in 2010 and remained above 20% for the first half of the decade. The most recent census data available, from 2019, places the rate at 14.4%. Source: US Census Poverty Data and Children's Defense Fund.

Wanted: Public-private partnerships, deficit spending, and carbon tax

Part II

In Part II of the program, Stephen Dover, chief market strategist and head of Franklin Templeton Investment Institute, interviewed Joseph E. Stiglitz, Nobel prize economist and professor at Columbia University, on June 29, 2021.

Key takeaways from the interview

- Post-2008, the extremely loose monetary policy and high levels of deficit spending sparked concerns over the long-term impact that excessive debt-to-GDP ratios could have on economic growth, and the threat of potentially excessive inflation. While this is certainly something to be monitored, some inflation may be positive for the economy, and we may need to accept additional deficit spending to get there.
- According to Stiglitz, we need interest rates to rise somewhat so that we have a more accurate cost of capital. Capital allocation needs pricing, and pricing gets totally distorted when you get down to zero interest rates. It would be healthier for the economy over the long run if we returned to a world with more normal interest rates.
- According to Stiglitz, we would have better economic performance overall, a better return on capital, if we had a better balance between the private sector and the public sector. And that includes a better balance in investments in infrastructure. There's a strong complementary relationship between private and public investment; they're not substitutes. They each have a role in our society.
- If we want companies to make sustainable decisions, they need to be aware of the consequences of those decisions. Right now, they don't get any signals. And that's where a carbon tax could play a very important role.

Don't fear deficit spending… but respect it

Dover

Post-2008, the extremely loose monetary policy and high levels of deficit spending sparked concerns over the long-term impact that excessive debt-to-GDP ratios could have on economic growth. As we move past COVID-19 and add trillions more to the national debt with stimulus packages, concerns over deficit spending do not seem as urgent. Is this something we should worry about?

Stiglitz

There's a lot of uncertainty about how far we can push this, but I believe we have not reached a critical threshold, yet. If we are not aggressive enough with fiscal policy, we could lose an enormous amount of growth. In 2010, we had a very slow recovery. We could have had a much faster recovery, and a much stronger economy, if we had invested in infrastructure in 2011, 2012, 2013 and 2014. Today we've hopefully learned that lesson. The only way we're going to prevent a "K" shaped recovery—where those at the top do very well and those at the bottom don't—is with a tight labor market.

If we have a little bit of an increase in inflation, it's well worth the price. We have tools to dampen inflation if it gets too high, and we now can monitor the economy much better than we could in the past. We have real-time data where we can see more precisely what's going on. I think we're in a much better position to take more aggressive action, to make these investments that will make the United States and the world economy so much stronger. In this way we will have a much more inclusive recovery and a more sustainable recovery.

Cost of capital can't be zero

Dover

You said something that really intrigues me as an investor about the pricing of capital. Since 2008, because of low interest rates and central bank quantitative easing programs, we don't really have a rational pricing mechanism for capital. As you said, this has increased social inequality as asset prices for risk assets have been pushed higher—some might argue artificially. It has also made it very difficult for investors to apply discounted cashflow models. When you don't have a sound discount rate, it makes it very hard to value assets. You're making the case that we need a base level of inflation so that we have proper capital pricing. Could you elaborate on that?

> "If we have a little bit of an increase in inflation, it's well worth the price. We have tools to dampen inflation if it gets too high, and we now can monitor the economy much better than we could in the past."
>
> **Joseph Stiglitz**

Stiglitz

There are many aspects to this. In recent years we've even had periods when real interest rates have been negative. That is to say, interest rates adjusted for inflation are negative. So fundamentally this means people have been paying interest to buy bonds. That's not a natural state of affairs. If you think about it, the scarcity value of capital shouldn't be zero. If capital has a scarcity value of zero it means we're out of business. What does it mean to allocate capital in a world where there's no scarcity? It just doesn't make any sense.

In terms of a discounted cashflow model, how do you discount a negative rate? It's ridiculous. It also means that relative values get all distorted. How do you adjust for risk? And one of the phenomena that you see all the time, related to behavioral economics, is the search for yield. As we saw back in 2008, bonds like those of Greece gave a return almost the same as German bonds. So the market was not adequately pricing risk. I saw the other day that it's happening again, that Greek bonds are now being priced very much like ordinary safe bonds. Things are better, but it's hard to believe that their risk has been fully eliminated.

The point is capital allocation needs pricing, and pricing gets totally distorted when you get down to zero interest rates. I think it would be healthier for the economy over the long run if we returned to a world with more normal interest rates.

Public-private partnerships drive innovation

Dover

How should investors be thinking about the proposals that you make for more fiscal policy, for a more balanced approach in terms of private enterprise and public spending?

> “Government is very good at doing basic research, but quite often, that last mile—bringing the product to market, requires the private sector. The COVID-19 vaccine is a real triumph of science, but it would never have occurred without government spending.”
>
> **Joseph Stiglitz**

Stiglitz
We would have better economic performance overall, a better return on capital, if we had a better balance between the private sector and the public sector. And that includes a better balance in our investments in infrastructure. You can’t ship your goods if the roads are deficient, or if the ports are deficient, or the airports are deficient, etc. It costs private investors’ money if infrastructure is not publicly supported. There’s a strong complementary relationship between private and public investment; they’re not substitutes. They each have a role in our society.

Consider a recent example when public investments proved vital. We’ve been investing publicly in basic research and development that discovered DNA, then mRNA, and then scientists at the University of Pennsylvania created an mRNA vaccine. All this was essentially government-funded research, but that provided the private sector with an idea, which then took it the last mile.

Government is very good at doing basic research, but quite often, that last mile—bringing the product to market—requires the private sector. The COVID-19 vaccine is a real triumph of science, but it would never have occurred without government spending. What is troubling is that government spending in basic research and development (R&D) is way down as a percentage of GDP, much lower than it was 50 years ago.

There are tools that economists use. We can look at the marginal or average return on investments in infrastructure and marginal average returns on investments in R&D in the public sector. The numbers are huge, much larger than the returns we’re getting from private investment. And because they’re complementary, more public investment will increase the return to private investment. I understand why nobody wants to pay taxes, but it’s very short-sighted. You’re not going to have a healthy society or a healthy economy if you don’t pay for these investments. And unfortunately, because we have so much inequality, it’s not going to be from the bottom 50%. You can’t squeeze water out of a rock, and there’s just nothing there.

Carbon is biggest social cost today

Dover
How about taxes and the issue of sustainability. We see globally in Europe, in the United States, and to some degree in Asia, many programs intended to promote sustainability. New regulations, new government policies, etc. But what we don’t see, by and large, is a tax on the externalities associated with companies that pollute. I would think that that would be a basic thing to do. How could governments use the tax system to promote a more sustainable future for the planet?

Stiglitz
I have argued very strongly for carbon taxes. In a market economy, taxes and prices guide decisions. There are thousands of decisions that every entrepreneur, every business, must make daily. Do you use this technology or that technology, do you introduce this device or that device? Many decisions are made. It would be ideal if some of those decisions reflected social costs. The big social cost left out of many decisions today is the cost of carbon. Because of greenhouse gas emissions, the world is getting warmer, and we’re seeing the consequences. Extreme weather events are increasing dramatically, and these have an enormous economic and social cost. And we are just at the beginning of this crisis. Climate scientists are very clear that there are dangerous non-linearities in the relationship between temperature change and environmental impact. A change in one degree may sound minor, but it will have an enormous impact. If we want companies to make sustainable decisions, they need to be aware of the consequences of those decisions. Right now, they don’t get any signals. And that’s where a carbon tax could play a very important role.

The path to a better tomorrow: It will take all stakeholders

Part III

In Part III, the panel discussion "Positioning for the Next Normal" centered on how to shift portfolios toward a model that recognizes societal welfare and sustainability concerns as equal to economic growth and GDP as measures of success.

Key takeaways from the interview

- What we measure affects our behavior. We need to better emphasize environmental, social and governance (ESG) impacts if we desire a more equitable and ultimately more economically viable world. The focus needs to shift from shareholder value to stakeholder value, where responsibility to the community matters as much as return to investors.
- Achieving our sustainability goals will require a team effort from corporations, governments and citizens.
- Transparency in sustainable investing practices is key. If consumers know where products come from and the ESG track record of companies, it will prompt change. The challenge is finding, aggregating and validating ESG data.
- If we do see some sustained inflation, it may be a good thing in the long term. The transition may be painful as interest rates rise and debt markets adjust, but in the longer term we will have a healthier signal on our cost of capital, facilitating better economic decisions and investor returns. Also important: inflation must be considered regionally, not as a global phenomenon.
- Sustainable companies can perform as well, if not better, than non-ESG compliant businesses. Companies implanting sustainable practices often have competitive advantages—higher energy efficiency, better productivity and more diversity leading to better ideas.
- New ESG regulations in Europe may drive global ESG investing trends. This may have real ramifications on cost of capital for companies going forward.
- Cryptocurrency and blockchain technologies can have huge upsides around access and democratization. But we can't ignore their massive and growing carbon footprints.

Shifting from shareholder to stakeholder

Even before the onset of COVID-19, companies around the world were beginning to embrace ESG ideals. The pandemic accelerated this trend. As Professor Stiglitz said, what we measure affects how we behave. Companies and asset managers need broader measurements to assess value and economic good, not just GDP or corporate earnings. We need to look at impact if we desire a more equitable and ultimately more economically viable world. The focus needs to shift from shareholder to stakeholder, where responsibility to the community matters as much as return to investors. Europe is leading the world in this regard.

As asset managers, we welcome this trend and support it. This creates differentiation between companies that are not aligned with this new normal versus those that are, highlighting investment prospects. During COVID-19, as long-term and material owners of the stocks of many global companies, we were able to reach out to senior management very quickly and advise them of our view on how they could behave more responsibly. For example, we could suggest they provide personal protection equipment to employees, extend health care benefits—including mental health care—and seek to ensure job security for employees concerned about layoffs. As owners of significant equity holdings, we have very good access to management.

We think about and interact with companies globally. For example, the issue of financial access is an important service for stakeholders, particularly in EMs. We support payment companies that enable individuals, some of whom may not have savings accounts or credit cards but do have cell phones, to make purchases through their electronic networks. Things like buying a cart to sell goods or making a payment for farmland. This type of model brings new people into the financial system, particularly underserved women, and has provided another channel out of poverty. From a global stakeholder perspective, we see this as very important for investing.

In addition, when we think about and evaluate sustainability and investments by industry, data security and customer privacy are material for our technology companies. Energy efficiency is key for our industrial companies. Food safety is critical for food manufacturers and restaurant companies, and hourly wages and opportunities for promotion are important assessments to make for highly labor-reliant industries.

In real assets, for example, we see attractive opportunities in structures that are providing social services to local communities, or buildings that are being built sustainably toward a net-zero carbon future. We see a green premium for efficient buildings, and a brown discount as regulations de-value older, less energy efficient buildings. From an investment perspective, this presents a great potential opportunity. We can buy older buildings, improve their efficiency, and make an attractive return.

All stakeholders need to participate

As global asset managers thinking about sustainable investing or ESG factors—including things like seeking net-zero carbon emissions—we must consider the implications for investment. How realistic is it that we can achieve net-zero and how do we get there? What does it mean for GDP growth and corporate profitability? Those are among the big questions to come up initially.

For example, look at hydrocarbons. They are a key element for global production and manufacturing because they're inexpensive. They've been used in the developed markets for a long time and developing markets now increasingly rely on them for economic growth. The externality costs—that is the costs to our environment and long-term sustainability—are not necessarily being measured, particularly in some EMs. So, the question is, as we transfer to alternative fuels, will it slow down productivity and the ability to grow economies globally? That is what makes all this so complicated.

Ultimately, we need all aspects of society involved. We cannot simply rely on governments, because there's not enough public capital to address all the sustainability issues we face. Governments help, but we don't need to sit and wait for regulation as the motivation to do the right thing.

Professor Stiglitz has argued that the only way we can achieve our sustainability goals is by enabling more government intervention and more government stimulus. This will require a team effort from all stakeholders—corporations, governments and citizens.

The good news is companies are beginning to shift culturally. Most notably in Europe, but North American companies are moving in this direction as well. Years ago, it was very hard to get companies to think about sustainability unless the government forced their hands. They generally saw it as something for non-profits, but not the private sector, which was primarily focused on shareholder returns. We've seen more recently, even in the past three years and accelerating through the pandemic, that companies have become much more proactive and are actually doing the work themselves. We also credit investors, that is the citizenry, for their engagement with companies. Communities can remind industry that they have a social license to operate, and they can do more and still be profitable.

Ultimately, we need all aspects of society involved. We cannot simply rely on governments, because there's not enough public capital to address all the sustainability issues we face. Governments help, but we don't need to sit and wait for regulation as the motivation to do the right thing. The economics paint a picture that forward thinking is beneficial to investors in the long run. We need investment from the markets, and this is a good thing because the economics align.

Transparency is key

More transparency and better measurement will accelerate ESG corporate behavior. If consumers know where products come from and the ESG track record of companies, we believe it will prompt change. We need to prove what we're saying is true. This is happening quickly with data democratization. We're asking more of companies in terms of their carbon footprint, their supply chain, etc. With that information consumers are empowered further to pick winners and losers. As investors, this is good because it provides differentiation that benefits companies that are forward-thinking on sustainability.

Linking sustainability to financial value requires measurement and logic models that connect how consumer preference can lead to a competitive advantage for certain companies. The challenge is finding, aggregating and validating data in a way that can prove to the market that sustainability-focused investments are valuable and attractive.

Sustainable does not necessarily mean sacrificing returns

Overall, investors are much more aware of ESG issues, but they are not willing to diminish their returns in exchange for better sustainability. The good news is we believe they will not have to sacrifice performance in the long run. We see the performance of companies that implement sustainable practices and often they possess a competitive advantage. They may have higher energy efficiency, better productivity and more diversity leading to better ideas. Sustainable companies can perform as well, if not better, than non-ESG compliant businesses.

Can SFDR go global?

The European Union's (EU) Sustainable Finance Disclosure Regulation (SFDR), which became effective on March 10, 2021, is a new initiative intended to prevent the "greenwashing" of investment programs. The SFDR will monitor and rate investment fund ESG practices. This will have a significant impact on how Europe invests going forward. Clearly this will move assets away from some of the industries that may not be as friendly toward sustainability. This may have real ramifications for cost of capital for those companies going forward. We think this regulatory program is quite interesting and could be replicated in other parts of the world.

Cryptocurrency regulation

As cryptocurrencies (cryptos) grow, we anticipate there will be more regulation. We are already seeing this in parts of Europe, and some of the more recent changes in the United States include taxation on cryptos. We also anticipate governments will begin issuing their own cryptocurrencies. China is already implementing a digital currency, while Australia, New Zealand and the United States have examined central bank crypto as well.

Cryptos are one use case of the exciting technology that is blockchain. However, cryptos require more immense computing power—which, of course requires electricity and energy—so the carbon footprint of cryptos is a huge weakness. This does not preclude other technologies built on blockchain or even other cryptocurrencies from being forces for good. For example, other cryptocurrencies may use similarly secure strategies called proof of state that don't require as much computing power.

In terms of social benefits, the concept of blockchain is about democratizing data. If you think about suppression around the world, it is often supported by information inequality. As more information is put on blockchain, this could have a democratizing effect globally. This could be a powerful trend. We are in the in very early days of the use case, but we expect this will be transformative for the future.

Panelists

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