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WHITE PAPER

Pulling away: Inequality as an ESG risk

“A market economy based on private property, if left to itself, contains powerful forces of convergence, associated in particular with the diffusion of knowledge and skills; but it also contains powerful forces of divergence, which are potentially threatening to democratic societies and to the values of social justice on which they are based.

‘The principal destabilizing force has to do with the fact that the private rate of return on capital, r, can be significantly higher for longer periods of time than the rate of growth for income and output, g.

‘The inequality r>g implies that wealth accumulated in the past grows more rapidly than output and wages. … The entrepreneur inevitably tends to become a rentier, more and more dominant over those who own nothing but their labor. Once constituted, capital reproduces itself faster than output increases. The past devours the future.”

Thomas Piketty, Capital in the Twenty-First Century

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WHITE PAPER

Pulling away: Inequality as an ESG risk

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When Thomas Piketty released his analysis of inequality in modern societies in 2013/14, he hit a raw nerve.[1] His book became an almost instant global blockbuster - a rare feat for an economic tome of some 700 pages - and triggered a wave of soul-searching among social scientists, including in the dismal science itself. Had we somehow missed how our economic system had become unhinged?

Both left- and right-leaning economists and commentators have since questioned Piketty's assumptions and conclusions. But there is little doubt that his book captured the zeitgeist and ignited a renewed interest in the economics and manifestations of inequality among a wider, often lay audience.

In this essay we briefly examine the current state of wealth distribution, its causes and the emerging threats to the status quo, to show why inequality is turning into an important sustainability risk - both at a macro and company level.

The right idea, at the right time

Piketty conducted much of his research in the aftermath of the global financial crisis of 2007/08, which had left many reeling from falling job and income security, stagnating wages and salaries, declining retirement income, and retreating social care and other public benefits. The next generation can no longer rely on education as a way to success and financial safety: today's graduates are found serving coffee or staffing call centres. And this is not just a Western phenomenon; China now churns out graduates at such a speed that many no longer find lucrative careers.[2]

In all of this, the '1 per cent' - the top percentile in the income distribution who wield significant corporate and political power - have been pulling away from the rest of the population, fostering wider resentment.

Growing debt as a source of financial inequality

An analysis of the relative rewards for capital and labour, as Piketty so aptly proves, is helpful in framing the problem. Yet the relative productivity of capital and labour is only part of the story.

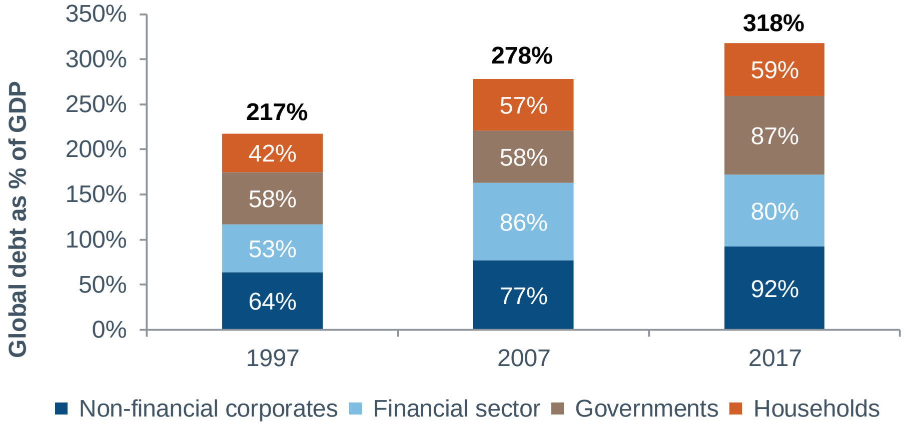
Under the influence of deregulation and financial innovation in the last half-century, residential borrowing has ballooned. Before the 1980s, only dedicated borrowers like savings and loan banks, commercial banks, or building societies provided lending for mortgages.

Vertical integration of mortgage lending, in which banks packaged up loans and sold them on rather than building long-term relationships, allowed them to offload risk onto third parties, distorting their incentives when issuing the loans. More layering meant more fees, making this process more lucrative irrespective of where the risk ended up. New instruments, especially collateralised debt obligations on mortgage-backed securities, were created by financial engineers not versed in the housing markets, who used techniques from the bond markets to package high-yield subprime as AAA-rated products.

Mortgage securitisation came to dominate the mortgage finance system, and mortgage lending particularly in the US ballooned. When the Glass Steagall Act was repealed in 1999, firms were allowed to participate in all roles of the securitisation process. This signalled the end of the regulatory segmentation of the US financial system and laid the foundations for the industrialisation of mortgage finance.[3]

On the face of it the greater availability of debt through mortgage liberalisation allowed more people to own property, reducing inequality, but over the longer term reducing credit standards.

Chart 1: At more three times GDP, global debt is much higher than before the crisis



Data as of Q3 for each year. Source: Business Insider UK, based on IIF, BIS, IMF and Haver data, January 2018.

We know now that it didn't end well. The resulting 2007-08 financial meltdown had severe global repercussions and triggered a credit crunch for private and corporate borrowers, which could have been expected to herald a reversal in global debt dynamics. Yet authorities stepped in to prevent the downward spiral turning into a depression, and with their extensive borrowing, global debt has continued to reach new highs.

Help for some more than others

The explosion in debt in recent years has come about as a result of central banks' extraordinary quantitative easing - a monetary experiment on an unprecedented scale. With central banks hoovering up bonds in sovereign and corporate markets, yields collapsed making it even more attractive to borrow.

The lion's share of these funds went into property markets, debt servicing, stocks, and bonds. While the central banks' actions staved off a global depression, little of their funds ended up in the real economy - in technological improvement, machinery, or research.

As the funds unlocked by the credit boom found their way into asset markets rather than the real economy, they inflated not just housing values but financial assets prices, too. This brand of debt-fuelled capitalism has not served everyone equally: the winners of this credit boom were those who could borrow the most and invest in real estate or financial markets.

Investments in property and financial assets do little to support productivity growth, which has been limited over the past decade, according to official figures. Yet it is productivity growth which generally allows for the gains of progress to be spread over larger shares of the working population, while financial asset price inflation concentrates wealth in the hands of investors.

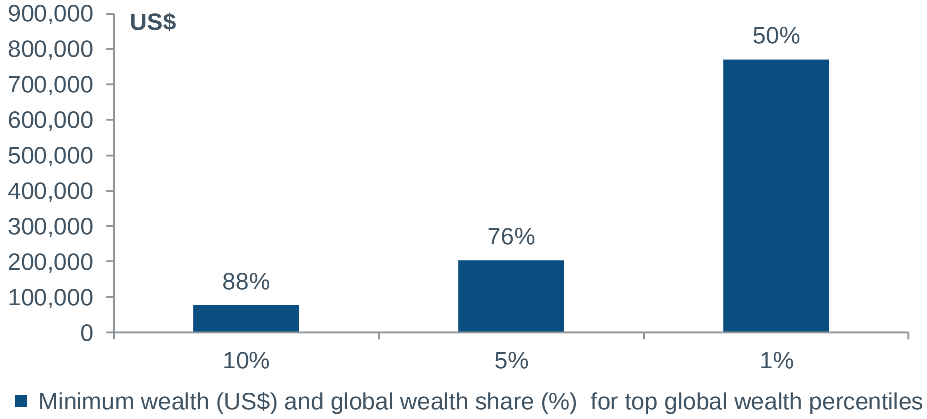
An analysis of despair?

Credit Suisse's flagship Global Wealth Report reveals the growing gap, 'propelled in part by the rising share of financial assets'.[4] It shows that the world's richest 1 per cent now own fully half the world's household wealth, up from 42.5 per cent at the height of the 2008 crisis. The top decile accounts for 88 per cent of global assets, while the bottom half of the income distribution own only 1 per cent.

The global number of millionaires has increased by 170 per cent since 2000, partly due to the overall increase in wealth but also because of rising inequality. The number of ultra-high net worth individuals (with a net worth of $50 million or more) has risen five-fold, making them the fastest-growing group of wealth holders.

The difference is large. To be among the wealthiest half of the global population, only $3,582 in net assets is required. More than 20 times that amount ($76,754) buys entry to the top decile. But to be among the wealthiest 1 per cent of world citizens, an individual needs $770,368 - fully 215 times the bottom half's cut off.

Chart 2: Most of the world's wealth is concentrated among small groups



Source: Credit Suisse Global Wealth Databook 2017, Fidelity International, March 2018

Significantly, it is the young who lose out the most. Those with low wealth are disproportionately found among younger age groups who have had little chance to accumulate assets. Millennials as a cohort are trailing their parents when it comes to home ownership, income, and other wealth criteria, despite being better educated. A small privileged group will ultimately inherit their parents' assets, but this process only reinforces the growing gap between the have and have-nots.

Debt, of course, is borrowing from the future. Future generations will have to pay off the debt, but are also faced with higher asset prices that make it harder, for example, to get onto the property ladder.

The economic argument for debt rests on productivity growth; borrowing from the future can work if it helps to increase future output and therefore enhances cross-generational wealth. But the combination of asset price inflation, new labour-saving technologies, outsourcing-based business models, and the decline of trade unions means that large parts of the labour force are left with little bargaining power, and are losing out.

This helps to explain the lack of wage pressure despite declining unemployment in the major economies. The Phillips curve dictates that US average earnings should be rising much more than they are; yet averages aren't much help when some smaller parts of the labour force mask the lack of upward opportunity for large groups of middle-income workers whose jobs are at risk of displacement by automation.

In previous instances of large labour displacements, productivity increased for all groups. The migration from agriculture into industry was triggered by new technologies, which made both agriculture and industry more efficient, ultimately leaving all workers better off. Today's displaced workers, however, often end up in lower-paid, lower-productivity jobs. These shifts do not lift wealth for the population as a whole.

Assessing investment risk

Piketty's ripples reached wide and far. Recent elections in the US, the UK, Italy, Russia and elsewhere had more than a whiff of nostalgia for a world remembered as more egalitarian and fairer. Governments can ill afford to ignore the resentment of the '1 per cent' when stagnant real wage growth is the norm for most voters.

But to what extent is inequality a risk that investors need to weigh up - one that can meaningfully affect the outcome? If it is relevant, how does inequality affect corporate behaviour? How will it affect long-term sustainability? What can, or should, companies do to play their role in addressing what might appear an immutable situation of macro-economic proportions, made worse by technological progress? How can we as investors even measure any risks involved?

These are questions that cannot be answered easily, but they are worth considering.

First, a concentration of wealth can harm demand, adding to the pressures from aging populations. Falling real incomes for the masses reduces their purchasing power, limiting companies' pricing power. This is not compensated for by the additional wealth in the hands of the rich, as the wealthy spend less and save more as a proportion of their income than poorer population groups do. In theory, retirees shift from saving towards spending accumulated assets on goods and services, but because of high wealth inequality this holds true for only a small portion of pensioners. In the US, for example, most retirees would need government transfers to sustain their pre-retirement consumption.[5]

Automation will probably add to downward pressure on wages, as it may well boost output faster than demand growth, and foster a more entrepreneurial, flexible working environment that creates more inequality and offers a weaker safety net. In Piketty's terms, increased automation will extend the relative share of income apportioned to capital versus labour from its trough in the 1970s.

Second, at an aggregate level, a system that creates high inequality through asset price inflation for property, stocks, bonds, or collectibles, without fostering productivity growth, may house a growing systemic financial risk, much in the way that a highly leveraged company can be brought down when the environment toughens. An over-leveraged system may not have enough buffers to withstand setbacks, meaning that initially isolated cashflow or liquidity problems can lead to waves of defaults that can bring down entire economies, resulting, in extremis, in economic depression.

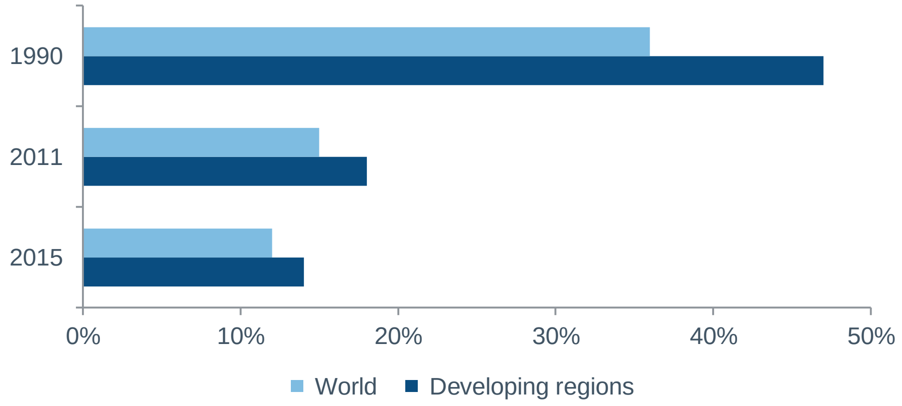
It is also possible such growing inequality undermines the pillars of the capitalist system itself. Capitalism is supposed to offer a meritocratic, differentiated, efficient allocation of capital, based on future returns. Second, efficient economic growth is expected to trickle down to rising wealth for capitalist societies overall, lifting people out of poverty. When wealth increases are too concentrated, trust in either pillar may erode. Free market politics may no longer be seen as promoting democracy, creating a safe space for populist movements.

This is hardly a theoretical scenario. Left-wing populism has had a resurgence in southern Europe and long-silent Marxist voices are boosting poll results for the UK's opposition Labour Party. Ultra-right-wing forces helped catapult US President Donald J. Trump into power and are taking hold in parts of eastern and northern Europe. In the Philippines, the highly controversial, self-proclaimed crime-fighter Rodrigo Duterte overthrew the political establishment in a landslide win in the 2016 presidential election, claiming in his inauguration he would tackle an 'erosion of the people's trust' in the leaders, the judiciary and public servants.[6]

Growth helps, and cycles aren't dead

At times, however, the inequality debate overshadows global economic improvements. Inequality may yet rise a little further, until asset prices run into obstacles. But the number and proportion of the global population that is lifted out of poverty continues to rise. As a percentage of GDP, global debt is no longer rising now that economic growth has picked up substantially. The ratio has dropped to 318 per cent, three percentage points off its high after four consecutive quarters of lower readings.[7]

Chart 3: Globally, extreme poverty has fallen significantly



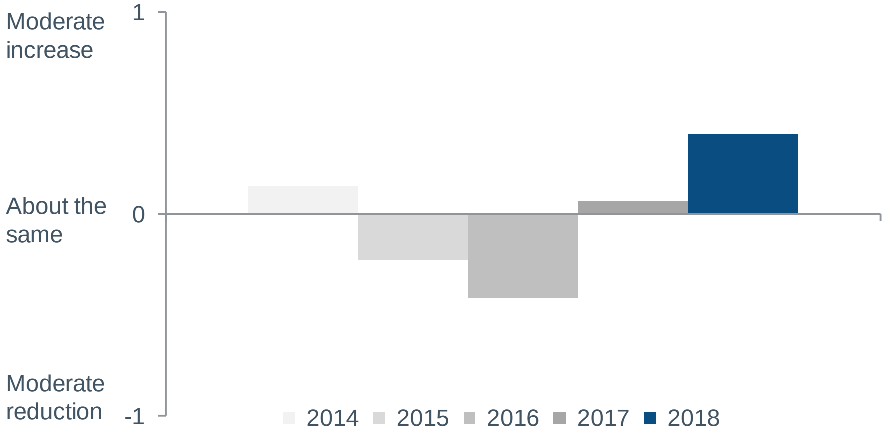
Percentage of people living on less than 1.25 U.S. dollars a day. Source: UN Millennium Development Goals Report 2015.

In addition, it is possible that current trends are to a large extent cyclical, rather than structural, following a decade of government austerity and tight corporate spending control. Wealth and income gaps may well narrow in the next decade, based on a relative fall in the returns on capital versus labour. This would be an environment in which the real economy feels better, but asset prices do not reflect as much optimism as they do now.

Indeed, for the first time in years, companies are investing widely again in their own productive capital. It is early days yet to see any impact on productivity, but it is probable that improvements in machinery, technology and other assets will boost companies' efficiency.

Chart 4: Companies' capital expenditures are recovering

Fidelity Analyst Survey average responses to: How do organic capex plans for your companies over the next 12 months vary vs the last 12 months?



Scale of -2 (significant reduction) to +2 (significant increase). Source: Fidelity Analyst Survey 2018

Applying the right tools

The third wave of automation is not just affecting blue-collar jobs; white-collar workers across a wide spectrum of skills will also see their working lives changed beyond recognition. This in itself will act as a leveller in wealth terms. But how this will happen is difficult to foresee, and applying 19th or 20th century tools to fix 21st century problems is unlikely to provide the right solutions.

Productivity measures may underestimate the degree to which modern technologies make people more productive, and new technological developments may cause further leaps in workers' productivity. Artificial intelligence need not replace human workers altogether but could enhance their output, leading to shifts in economic rents and reducing inequality. Roles which require a high level of human physical and interpersonal skill are well-placed, for example. Skilled labour, care work, personal training, creative industries, entertainment and so on are all areas which could command a higher economic rent than historically. Stand-up comedians make a fortune these days...

We all famously overestimate the impact of new technologies in the short term, but underestimate it in the long term, as the American researcher Roy Amara pointed out.[8] This is not new; hyperbolic early predictions gave way to scepticism in the very first stages of steam locomotion much as they did with computing, artificial intelligence or gene technology. Yet both AI and genomics now appear on the cusp of game-changing applications.

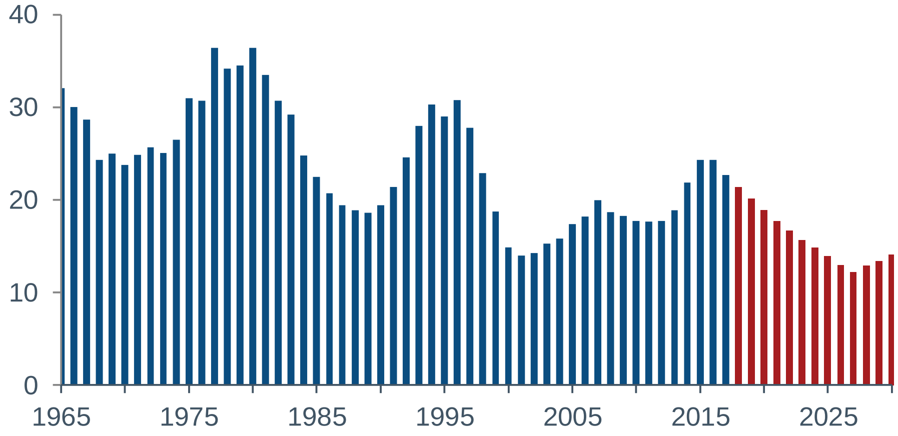
This is important when we're assessing how companies' behaviours and roles are changing. Robots will not be replacing our roles within a few years, but our working environment will almost certainly change substantially over the next decades.[9]

Applying a pre-digital reference framework to this maelstrom may lead us astray: we won't see the big picture and could end up choosing solutions to emerging problems that only aggravate them, while missing new opportunities. This is true for investors as much as for companies, governments, and monetary and regulatory authorities.

Today's customers have low switching costs, brands can gain and lose their saliency in remarkably short periods, and industries and sectors become increasingly hard to define. That makes it more difficult to identify what it takes for companies to survive in the longer term.[10] Companies facing similar end markets or trading in similar products could well experience radically different fortunes that are not explained by conventional analysis. This is why it is so important to analyse how businesses look after all stakeholders in order to assess areas of vulnerability and areas of marginal advantage.[11]

Corporate risk analysis is dominated by statistical models that are based on a normal distribution of outcomes and assume the relatively recent past is the best guide to the future. However, what most investors really care about is permanent loss of capital, which is most likely to occur if there is a sudden re-evaluation of the duration or quality of a company's earnings. So there may be greater value in a risk process driven by issues such as employee welfare, corporate governance structures, engagement with regulators, and the quality of financial reporting. These can reveal where vulnerabilities reside.

Chart 5: The average company lifespan on the S&P index is shortening



Each data point represents a rolling seven-year average of average lifespan. Source: Innosight Executive Briefing '2018 Corporate Longevity Forecast: Creative Destruction is Accelerating', Fidelity International, February 2018.

An ESG premium for a societal consciousness

Only a decade or two ago, consumers bought what was available in the shop or accepted their doctor's remedy; they had little access to, or knowledge of, alternative options. But the internet is great agent of equality. It challenges the very notion of expertise and fosters competition. In a world where information is transparent and instant, looking after your own narrow corporate goals without thinking about the wider consequences can lead to significant, and lasting reputational damage.[12]

Successful companies of the future will need some form of societal consciousness. It is no longer the case that customers only care about the product, suppliers about the terms, shareholders about the bottom line and regulators about the rules. Their relationships are quickly becoming much more fluid and their interests intertwined. That means a change of behaviour for companies, as BlackRock's Founder, Chairman and CEO Larry Fink pointed out in his seminal 2018 letter to CEOs: 'To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society.'[13]

Companies are waking up to a reality in which customers can vote quickly with their feet, while regulators turn up the heat and investors force through changes. Policies that affect inequality in value chains, gender or race opportunities, health, nutrition, the environment or education can all come under scrutiny. Pay gaps between the lowest and highest-earning employees are already being watched (even if they don't reflect wealth effects).

Enhancing shareholder returns at the cost of labour may well become more difficult. Companies that stop investing in their population through education, infrastructure, or health, for example, are hollowing out their workforce, which takes a toll not just on workers directly but also affects consumption. Companies, therefore, need to re-educate themselves on their role in the wider ecosystem, which is not sustainable if the fruits are not shared acceptably.

Social and economic inequality may be new on the ESG agenda. But it's here to stay.

[1] The first French edition was released in 2013; an English one followed in 2014. Amazon couldn't keep up deliveries and it quickly topped the bestseller list of the New York Times, which called Piketty 'An overnight intellectual sensation' ('Hey, Big Thinker')

[2] A record 8 million Chinese students graduated last year, nearly 10 times as many as a in 1997 and twice as many as the US produced. Many complain of difficult job markets while employers deplore a lack of relevant skills. China now produces twice as many graduates a year as the US, World Economic Forum, 13 April 2017.

[3] The Transformation of Mortgage Finance and the Industrial Roots of the Mortgage Meltdown, Neil Fligstein and Adam Goldstein, University of California, Berkeley, October 2012.

[4] 2017 Global Wealth Report, Credit Suisse Research Institute

[5] Labor 2030: The collusion of Demographics, Automation and Inequality, Bain & Company, February 2018

[6] Rodrigo Duterte sworn in as Philippines president, BBC News, 30 June 2016

[7] Institute of International Finance Global Debt Monitor, January 2018.

[8] Don't write off the next big thing too soon, Matt Ridley, The Times, 6 November 2017.

[9] In their report on the 'Collision between demographics, automation and inequality', Bain & Company conclude 'the depth and breadth of changes in the 2020s will set apart this transformation from many previous ones'.

[10] Innosight, a strategy and innovation firm, warns in its latest two-yearly report on corporate longevity that the pace of creative destruction is accelerating, issuing a 'gale force warning to leaders' that at the current and forecasted turnover rate, nearly 50 per cent of the current S&P 500 will be replaced over the next ten years. Its research reveals companies' average tenure on the S&P 500 has dropped from 33 years in 1964 to 24 years in 2016 and is set to shrink to just 12 years by 2027.

[11] Industry must train fresh eyes on sustainability, Paras Anand, Financial Times, 1 October 2017.

[12] When Starbucks became a poster child for tax avoidance in the UK in 2012, its customers deserted to its rivals in droves, dismayed that it might have been legally in the right yet did not play its role in a civil society with a tax-based solidarity system. The company later struck a deal with HMRC to waive tax deductions and pay £20 million in voluntary corporation tax. Starbucks blames UK profits plunge on Brexit and slowing growth, The Guardian, 13 April 2017.

[13] 'A Sense of Purpose', 2018 Annual Letter to CEOs, Larry Fink, founder, chairman and CEO, BlackRock.

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