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One major lesson we have learned in our decades investing in the capital markets is that investors get the most painful bites not from the snakes they are watching intently but from the ones they don't see lurking in the grass. It's not that they don't know the snakes are there, somewhere; but at some point, after having gone long enough without a sighting, the markets just seem to forget about the snakes entirely. Until… well, you know.

We chose this idiom on purpose for its many meanings. Regular readers will recognize our long-standing theme that volatility is driven by the uncertain, not the certainly bad; markets are surprised by missed expectations more than by validated ones. Therefore, the largest asymmetric risks to the market (in either direction) are those which represent plausible scenarios that contradict market expectations. However, another meaning in this idiom as a metaphor for risks points to their insidious nature, whether intentional or not. The markets are full of participants who make a living by lulling investors into a false sense of comfort, even if they sincerely believe in the feeling of safety they are peddling.[1]

We have all read a lot about supply chain disruptions, energy prices and (most of all) inflation. But what has been particularly interesting to us are not the circumstances themselves, but the lack of critical thinking found in the lazy interpretations of Wall Street economists. Investors rely on such "experts" not to point out what is obvious to the naked eye but rather to reveal what is hidden and to help anticipate and prepare for the unexpected. Like credit ratings agencies, economists will ultimately be reactive to the news, moaning that the next issue, just like the current ones, came out of nowhere. But they didn't really. They were in the market's blind spot all along, potential outcomes which investors have been lulled into ignoring, disguised in the grass.

Trust Us, We're Kool: A Cautionary Tale for ESG Investors Who Actually Care

Philip Morris International, the non-US manufacturer and distributor of the Marlboro cigarette brand, announced in August 2021 that it would be issuing an ESG bond.[2] Yes, you read that right.

Before we get into their "transformation" – their term,[3] not ours – a little bit of history is in order. Philip Morris International was spun off from Altria Group, the rebranded Phillip Morris parent company. The name was changed nearly 20 years ago, though the company claims that this was not done to run from the negative repercussions of the bad behavior of its iconic cigarette business. At the time, the company also owned Kraft Foods and beer producer Miller, and the

1 Even within our relatively small sandbox of fundamental credit and capital preservation, we hear managers represent asset classes (such as SPACs) as "fixed income" when they are so clearly not. Sure, the thesis feels logical, and it may work for some time, but ultimately, only fixed income securities act like fixed income securities all of the time.
2 For those astute readers who paused long enough to Google the Kool cigarette brand, we know it's not made by Philip Morris, but we couldn't let a minor distinction without a difference get in the way of a perfect headline.
3 The first menu item on their website says so. We also find this entire site to be painfully desperate. Over 70% of their 2Q21 revenues were from traditional combustible products (i.e. cigarettes), but the marketing and legal teams have ensured that those brands are nowhere to be found.

argument was that the company was more than just tobacco. This made sense; being viewed as only tobacco wasn't a great recruiting tactic, certainly not for any openings they may have had on the PR team. Within about a year, Altria had sold Miller and brought Kraft Foods public in an IPO as the first step toward disposing of it as well. This left Altria as a rebranded tobacco company, and though we don't know for sure whether that was the goal of the rebranding all along, that PR team certainly couldn't have been too upset about the outcome.

Not long thereafter, Altria spun off Philip Morris International (PMI). The reasons were clear: Wall Street was clamoring for the company to unlock shareholder value by freeing the international subsidiary from "the legal and regulatory constraints facing its domestic counterpart."[4] Put another way, the origin story of PMI certainly wasn't particularly noble. Altria retained Philip Morris USA, and since then, has made investments in Juul and other smoke-free offerings. Their public persona is similar to that of PMI, so much so that, with US-based litigation and restrictions seemingly in the rear-view mirror, Altria attempted to merge with PMI, allowing the former to benefit from stronger cigarette sales in emerging markets while providing access to the rapidly growing US vaping market to the latter. Ironically, health issues associated with Juul and revelations that the rapid growth was at least in part due to aggressive marketing and product development targeted at children[5] led to the two companies scrapping their merger plans, for now.

So here we are, with a company who gets a large majority of its revenue from cigarette sales but hides those product lines on its website attempting to issue what it unironically calls "business transformation-linked financing" to try to get their company, if not their entire industry, off the ESG naughty list. After all, most ESG investors explicitly exclude the tobacco sector from their portfolios. But the trick here is that this move is not intended to appeal to ESG investors whose capital is ultimately used to buy the bonds. It is intended to appeal to ESG investment managers who deploy that capital on behalf of those investors.

The truth is that ESG investing is hard. It is not so hard that one can't see through the poorly veiled cynicism with which PMI is attempting to tap a growing source of capital that, at worst, is a PR win for the company. At the same time, this effort could potentially insulate PMI from reduced access to more traditional capital markets, especially in Europe where it is based and where investors are rapidly mainstreaming ESG mandates. But properly evaluating key ESG risk factors for an issuer takes a lot of work.

Moreover, since ESG risks do not have standardized disclosures like financial information does, explaining strategies to clients often requires that an investment manager be willing to educate. This is why many managers choose to outsource their ESG work to third parties or simply resort to negative screening, which research has shown to be a poor approach to ESG.[6] By doing so, these managers have plausible deniability if a portfolio company behaves irresponsibly. It gives them someone or somewhere else to blame. That said, if that someone else is not doing the work themselves, or if the rules governing what is and isn't appropriate aren't sufficiently rigorous, those managers face a different risk: being accused of greenwashing their portfolios.

For those who aren't familiar with the term, greenwashing is the act of making investments which only superficially appear to fit a sustainability mandate. By doing so, a manager may have many

4 "Altria to spin off Philip Morris International". NBC News. Associated Press. 29 August 2007.

5 Seriously? Does anyone bother to learn from the past anymore?

6 For more on this, I encourage you to review the Wharton research we cite in our piece, "ESG: A Data-Driven Definition".

clients who don't notice that they have a number of irresponsible issuers in their portfolios. This is very likely in portfolios for which the ESG effort is largely the result of a negative screen of "bad" sectors.[7] This is also likely among those managers who have outsourced their ESG research, but not for the same reason. Indeed, third party services give an air of credibility and rigor to a due diligence conversation. That said, we would ask readers to consider if they would invest with a manager who only buys stocks rated "Buy" by the research team at Bank of America Merrill Lynch. Or perhaps, they would prefer a manager who only buys stocks rated "Buy" by the research team at JP Morgan. What happens if the two research teams disagree? Which manager is better?

This example will strike some readers as absurd, and it should. But it is no different from hiring an ESG manager who relies on an outside party to do their ESG research. ESG factors are risk factors, and managers are hired to evaluate risks. If that work isn't native to the investment process and is instead simply an overlay or filter based on some external determination not ingrained in the manager's risk philosophy, then greenwashing is not just a possibility but a likelihood.

Failing Up: The Fraud of the Green and Sustainability-Linked Bond Market

What about green and sustainability-linked bonds, then? Portfolios that rely on such labels may be the most greenwashed of them all. Why? Because the decision as to what constitutes a green or sustainability-linked bond is mostly left to the capital markets process. This is where PMI hopes to fit in. They have no business issuing ESG bonds, and managers who claim to offer ESG strategies have no business buying these "business transformation" bonds. Issuers like PMI will seek to opportunistically raise capital with the lowest cost and fewest restrictions possible. The financial sector's socially responsible bonds are a prime example of this. Many banks issue bonds which are marketed as requiring them to use the proceeds to provide services to underserved communities. But a careful reading of the language in the indentures show that they simply "aim to" use a like amount of capital. There is no earmarking or restriction on the capital raised, and without the ability to verify or be held accountable, there are no real consequences. We discuss this more later; suffice it to say here that a commitment without consequences is at best a promise and most likely just a marketing ploy.

The banks have what some consider a valid argument for creating this loophole: Restricted capital cannot get the same regulatory liquidity credit as unrestricted capital. However, just as with Phillip Morris International, this response caters to optics. The truth is that not every issuer can or should be allowed to participate in markets which are intended to fund ESG progress if that issuer cannot make a sincere and enforceable commitment. Sometimes, the best way to contribute to progress is to recognize that we are not the star in every story, show some empathy and just get out of the way. These issuers would be well-served to learn this lesson: This market is not about you.

Which begs the question: Why would serious investors allow opportunistic issuers to undermine the credibility of the entire green and sustainability-linked bond market? They probably wouldn't, but the ecosystem of intermediaries they hire doesn't share their sincerity. Bankers who are

7 Asking the question is often not sufficient to determine if this is a manager's primary method of ESG "research." Most investment management firms are skilled at saying one thing and doing another. We urge readers to push their managers in due diligence and force them to discuss examples and detailed processes to separate the sincere from the insincere.

paid by issuers only push back on issuers when they are forced to do so by fund managers. And herein lies the insidious truth about green and sustainability-linked bonds. Many managers have made a good living by convincing investors that they are fighting the good fight. They point to consequences built into green and sustainability-linked bonds. In some structures, if a company doesn't meet certain targets, coupons can increase; in others, coupons may decrease upon reaching certain goals. Many managers will wax eloquent about their quest to make sure these targets are sufficiently meaningful and represent true progress. If they are too easy to meet, then the consequences have no teeth, they argue.

But the problem here isn't in the targets companies must meet. It is in the incentives of the managers. If they are being evaluated by the outside world based on performance, they will seek the highest total return available within their universe. If that universe is green and sustainability-linked bonds, marketed in an ESG strategy to investors, the highest total return comes *when companies miss their targets*. If a portfolio contains bonds most likely to miss their targets, it will generate a higher total return than one in which coupons are lowered or not raised because the company was successful in its ESG goals. Investors should not be so naïve as to believe the managers aren't fully aware of this loophole.[8]

Notwithstanding the fact that the broader investment manager community probably would prefer this not to change, we are compelled to ask the obvious question: How could this be improved? The answer can be found in none other than the very bond documents that govern the green and sustainability-linked bonds (and all bonds for that matter). In all bond indentures, companies are required to meet certain covenants. In many cases, especially as the covenants pertain to financial metrics such as leverage, free cash flow and additional debt incurrence, a failure to adhere to the covenant triggers an event of default. The point of these types of technical defaults (distinguished from a default caused by a failure to pay interest or repay principal) is to give investors the opportunity to accelerate the repayment of their principal early enough to minimize or possibly entirely avoid any principal loss. When this happens, the company must raise additional capital, offer concessions or accept a loss of access to capital markets. If a company is too impaired, the investor will lose money.

The key characteristic in these default triggers is *existential risk*. The company's existence is at risk. The investors stand to lose principal if they remain invested in companies who are likely to trip a covenant. Since most green and sustainability-linked bonds are issued by investment grade companies, and since the consequences of failing to meet a target are typical small adjustments of a coupon (+0.25% per annum is not atypical), there is no existential risk to the company. Further, there is not only no real principal risk to investors; they actually win. The circumstances set up in these types of bonds is cheap to fail for the issuers and beneficial to fail for the managers.

A more aligned ecosystem would be one in which ESG triggers were set up as covenants, accelerating repayment of debt if a company fails to meet them. This would result in ESG factors impacting credit ratings, which would finally force the credit markets to face the reality that ESG

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8 There is a counterargument worth sharing here. It is true that the executives of a company which doesn't live up to its commitments lose credibility, and possibly, their jobs. Therefore, regardless of manager incentives, it may still be in the best interest of the issuer's management team to meet its targets, in which case, increasingly difficult goals may have some opportunity for impact. However, our issue here is not with the effort to hold companies accountable to meet objectives that demonstrate legitimate progress. Our issue is with a market ecosystem making the case that, in order to make sure that happens, investment managers will act contrary to their own incentives and interests, for possibly the first time in the history of the financial services industry. Yeah, sure.

factors are credit factors. Until then, we must call green and sustainability-linked bonds what they are: cynical ploys that enable the Wall Street capital markets machine, which includes fund managers, to market ESG without actually aligning performance with progress. This won't always be the case, but it is today. And if ESG factors are not part of the credit process at the issuer level, there is little hope that a portfolio with these misaligned incentives at the issue level will accomplish its goals.

We caution even the slightest ESG-interested investor to avoid such strategies, less-rigorous and rooted in marketing, where managers hope that no one will notice (or care) that they have to catch up with rigor when the markets require it. At Zeo, we prefer to be prepared with a diligent and consistent process from the start. Our approach is not a fit for everyone, but it is sincere and we believe more likely to deliver consistent results with fewer surprises over the long term.

Chairman Powell Has Just About Had It Up to Here with You, Young Congress!

Fed Chairman Jay Powell is frustrated. His word, not mine.[9] In a recent public appearance, he said increased vaccination rates and stopping the COVID-19 delta variant "remains the most important economic policy that we have." Then, he cited the increasingly dire global supply chain breakdowns as a driver of inflation into 2022. In these two comments, Chair Powell issued more than economic guidance. These comments were a continuation of a theme we have seen from him for some time now: Political leaders are falling down on the job.

We have been writing for some time about Powell's attempts to explain that many of the challenges faced by the economy since the pandemic began were best addressed through fiscal policy. What was originally an objective economic opinion has increasingly become a frustration. The 24/7 news cycle, the siloed nature of media consumption and never-ending political campaigning seems to have rendered legislators in Washington, DC incapable of governing. In the absence of more precise legislative solutions, however, the Fed has attempted to fill in the void with a much cruder set of tools the best it can, all the while knowing that it may not be sufficient. It seems Mr. Powell has simply had enough.

Meanwhile, the Chairman has been much maligned by Wall Street economists for his view that recent inflation may be transitory. Many see the improving top-line unemployment figures and the latest inflation measures as signs of a successful and sustained post-pandemic economic recovery which the Fed isn't willing to acknowledge. They argue the Fed is risking overheating the economy and should reign in the money supply by raising rates sooner.[10]

Mr. Powell addressed these criticisms in this same appearance, commenting on the supply chain challenges as resulting in a stubbornly high inflation rate. What is important to understand in his comments is the implication that there is "good" inflation and "bad" inflation. Good inflation is driven by a growth in demand from broad-based economic strength. Bad inflation is driven by

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9 Cox, Jeff. "Fed Chair Powell calls inflation 'frustrating' and sees it running into next year." CNBC.com, CNBC, 29 Sept. 2021, https://www.cnbc.com/2021/09/29/fed-chair-powell-calls-inflation-frustrating-and-sees-it-running-into-next-year.html.

10 It may be worth nothing that, from the other side of the spectrum of economic ideology, Senator Elizabeth Warren told Chairman Powell, "Your record gives me grave concerns. Over and over, you have acted to make our banking system less safe, and that makes you a dangerous man to head up the Fed…." In our experience, when a policymaker draws criticisms from both sides for simultaneously being too aggressive and not aggressive enough, it probably means she or he is striking the right balance.

a drop in supply or a less comprehensive display of discretionary spending. It is no secret that the pandemic's impact on the economy disproportionately impacted low-income households. Meanwhile, the issues in the global supply chain point to a supply-driven catalyst for the increase in prices the country has been experiencing.

Indeed, the Fed chairman has been consistent from the start. What he has seen as transitory inflation is likely a reflection of the discretionary spending flexibility afforded not to those who are most vulnerable in our society but to those who weren't financially impacted by the pandemic in a material way. In addition, the Fed's focus not just on top-line employment metrics but on minority unemployment gains is yet another example of a policy aimed at sustained inflation. Mr. Powell seems to have no intention of getting head-faked by the wrong kind of inflation. The absence of legislative resolve simply prolongs the transitory nature of circumstances which are getting in the way of the Fed's intended outcomes.

This all leads to a more interesting line of thinking than whether inflation is transitory or sustained if one is seeking actionable insights. While most of Wall Street seems to still be singularly tracking inflation, we have spent the last year following the Fed's eyes to its intended target: employment. We won't rehash our prior analysis any further here,[11] but we would like to dig into some other less understood takeaways from recent employment statistics. Bloomberg recently published a well-research opinion piece by Karl W. Smith[12] which makes some interesting observations about the nature of the recently released August jobs data. Put simply, while new hires are not materially different from the same period last year, the primary difference is in the number of people who quit their jobs. The August 2021 quit rate was materially higher than in 2020, and in general, the quit rate in the US workforce has been steadily rising all year.

Mr. Smith draws a notable contrast to what happened in the workforce after the 2001 recession, in which a confluence of events led to an excess of available unskilled labor. This set the stage for a nearly two-decade trend in which corporate America was able to do more with less, driving revenues up while lowering the share of costs associated with labor. Employers could offer fewer or less attractive benefits, invest less in training and professional development, and generally avoid those types of investments in the workforce which make the people more valuable, not just to the company but to its competitors. With the possible exception of the few years right before the pandemic, voluntary rotation out of the labor market was brought to a halt. Put simply, it was a buyer's market when it came to hiring, with the companies holding much of the power.

The subtext here is that the stock market became dependent on both the increased profits and the increased growth rates that came from this material change in costs. One way to see this is through the market's price-to-earnings (P/E) ratio, which can be used to visualize the market's future earnings growth assumptions relative to current levels. Since the price of a company's stock generally reflects investor expectations of *future* earnings, the ratio of that price relative to recent actual earnings would go up with higher growth expectations, and vice-versa. As seen in Figure 1, what was a relatively range-bound value has reached levels only seen one other time in the last 140 years.

11 If you missed our previous comments on the Federal Reserve or just want to relive the experience, you can read our thoughts here and listen to Marcus on Bloomberg Radio.

12 Smith, Karl W. "Workers Who Quit Their Jobs Could Improve U.S. Productivity." Bloomberg.com, Bloomberg, 14 Oct. 2021, https://www.bloomberg.com/opinion/articles/2021-10-14/workers-who-quit-their-jobs-could-improve-u-s-productivity.

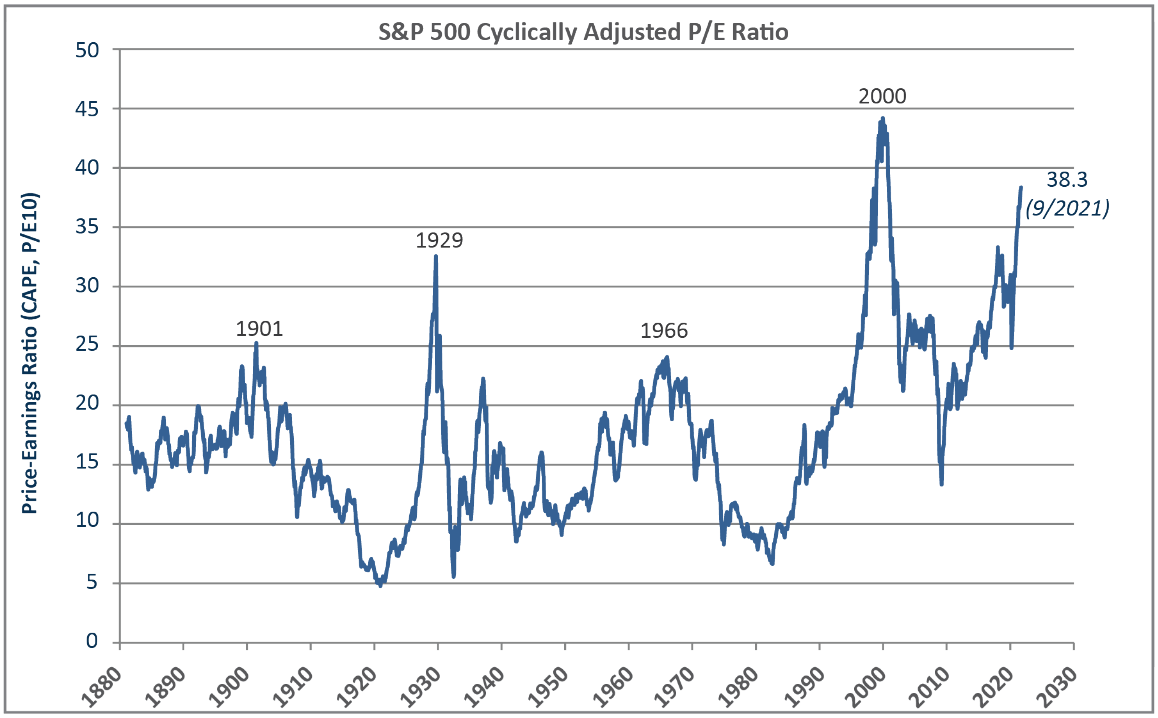

Figure 1: Shiller Cyclically Adjusted P/E10 Ratio for S&P 500. Note that the P/E10 ratio uses an average of the prior 10 years of annual P/E ratios to reduce impact of wild swings common in P/E ratio calculations. (Source: Online Data - Robert Shiller (yale.edu))

Notably, that last time (2000) was another period in which employee wages were not increasing substantially. For those who may not recall, the Fed was perplexed at the time by the failure of wages to keep pace with the economy and the markets. We know now that some of what caused wages to lag was the increased dependence of corporate America on non-cash compensation, such as stock options and other conditional payouts. Much of this compensation vanished when the dot-com bubble burst in 2000. However, unlike in 2000 and even 1929 (the last time the P/E ratio in the markets was near where it is today), the shock to the system came from a health crisis which triggered much of the workforce to reevaluate not just economic stability but satisfaction and fulfillment. Mr. Smith's observations point to an insight which is not so much about the present state of the markets as it is about the future. The quit rate we are observing in the economy today speaks much more directly to a potential reversal of this trend of doing more with less. Employees have had enough, and the pendulum may be swinging the other direction. We may be entering a seller's market when it comes to hiring.

If this is indeed the case, and we believe it may be, employers will have to do something they haven't had to do for nearly two decades: increase wages in a long-term committed way, improve benefits and otherwise offer opportunities for advancement and education to meet the needs and demands of a newly empowered workforce. We have seen this sort of dynamic already in small pockets of skilled workers (e.g. engineers in Silicon Valley), but we believe this effect may need to be more encompassing. In this new model for the labor market, earnings growth would, on average, go down relative to the pace of growth over the last 20 years. This probably means forward-looking P/E multiples are too high. We believe such a circumstance would point to a potential sustained choppy and possibly downward period for the stock market, some companies more than others.

So how does one mitigate this effect? First, it may make sense to de-risk an equity portfolio, finding refuge in the high yield market where credit can have more insulation from the profitability decline in companies selected for resilience factors such as cashflow and liquidity. Second, this is exactly the type of situation in which ESG-focused portfolios can shine. The most direct mitigating factor for this scenario we have described is an ESG one: How does the company treat its workforce? The companies most likely to weather the potential push-and-pull between profits and happy employees are those who already have happy employees.

The neat trick that Chairman Powell has pulled off here is that he has provided the Fed with exactly the leeway it needs to be patient. If labor costs increase, we would expect to start to see that flow through in earnings toward the latter half of 2022 or early 2023. This decline in profitability should coincide with a more democratic increase in discretionary spending ability across the economy. What may be transitory inflation today, propped up for a frustratingly prolonged period, could very well give way to a more sustained inflation right around the time the Fed is expecting to raise interest rates. We are sure Mr. Powell would have preferred to see inflation tick down in between, and he may never get the credit he deserves if Wall Street just assumes he was wrong all along. After all, this will also mean a rotation of wealth from Wall Street to Main Street, the reverse of what we have seen for the last two decades. But we will know the truth and are grateful that the Fed has decided to be the adults while our elected officials act like children.

We have said it before, and we will say it again: Just because a risk does not manifest itself does not mean it didn't exist. The history of the markets is disproportionately filled with the stories of those who didn't get bitten by snakes. But did they see and avoid them or were they just lucky? It will come as no surprise that we have a bias toward intentional effort and outcomes. We don't see our job as a game of chance on behalf of our clients; we see it as a responsibility which demands vigilance. We work hard to anticipate risks, plan ahead and be transparent about our process to deliver on our mandate. And we appreciate that our clients do the same. To the risk managers out there, watching the grass intently to spot the hidden snakes, we see you, and we hope you see us too.

As always, we are available for your questions, comments or feedback. We thank you for your continued support and confidence in our management.

Sincerely,

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