INVESTMENT INSIGHTS

Exploring the risks in supply chain management

MAY 2024

New York Life Investments

New York Life Investments views responsible investing[1] as an holistic approach to evaluating risk and opportunity. As stewards of our clients' capital, we take this responsibility seriously.

Our multi-boutique family of asset managers - with solutions as diverse as the clients we serve - utilize this holistic approach in an effort to build better financial futures.

Risk management in Supply Chains: Connecting the dots

Supply chains are vital to many businesses. As they grow more complex, companies are exposed to a wide range of risks, many of which are linked to changing regulations, geopolitical risk, and natural disasters. These particular types of challenges fall under the category of environmental, social, and governance (ESG)-related risks, and include extreme weather, scarcity of natural resources, labor exploitation, corruption, and more. To strengthen supply chain resilience, companies need to understand these challenges and have plans in place to manage these potential problems. If not managed effectively, ESG risks within supply chains can adversely affect a firm's financial performance—resulting in revenue losses and increased expenses, which may ultimately affect investment performance.

People don't tend to pay much attention to supply chains until something goes wrong—for instance, empty store shelves or backordered shipments.

For many firms, ESG risks in supply chains can adversely affect direct operations. For example, a semiconductor manufacturing facility in Asia may experience direct damage from extreme weather— disrupting production or transportation routes. Delays in shipping or delivery orders could cause cascading disruptions for a wide range of industries (e.g., computers, smartphones, automobiles, medical equipment) that use semiconductor chips as product inputs. Another example can be seen in the food and beverage industry. For instance, a food manufacturing company that relies on raw agricultural commodities such as fish, rice, and wheat sourced from potentially water-stressed regions, could see production negatively affected by climate changes that cause rising temperatures or sea-level changes that result in the development of toxic algae that impacts water quality. In both examples, supply chain disruption could create shortages of components, finished goods, and/or agricultural commodities that can increase consumer prices—and indirectly impact potential investment performance.

Overall, assessing supply chain issues and their impact is extremely complex, potentially making ESG risks even greater than expected.

Examples of common ESG risks in supply chains

ENVIRONMENTAL

- Climate change
- Water usage
- Land degradation and deforestation
- Biodiversity loss

SOCIAL

- Human rights abuses
- Violence and conflict
- Community rights violations
- Labor exploitation: Child and forced labor, modern slavery, gender inequality
- Workplace health and safety; discrimination and harassment

GOVERNANCE

- Breach in business ethics: Corruption, bribery, and fraud
- Lack of transparency and governance accountability
- Misleading information about ESG performance

Potential adverse outcomes from ESG supply chain risks

OPERATIONAL

- Disruption of production processes and deliveries
- Higher incidence of product defects and waste
- Greater operational inefficiencies

REPUTATIONAL

- Loss of social license to operate (acceptance by employees, investors, and the public)
- Loss of brand value
- Shifts in consumer loyalty
- Loss of investor and shareholder confidence

REGULATORY

- Failure to comply with current rules and regulations
- Government fines and penalties
- Loss of market access
- Failure to maintain compliance with future regulatory changes

Investment managers require broader awareness of ESG risk factors

Supply chain disruptions have the potential to diminish consumer sentiment, employee engagement, and investor confidence, posing significant challenges for businesses. For an investor, these financial consequences can contribute to declines in financial performance and the loss of equity value.

Economies heavily reliant on manufacturing, such as China and the U.S., will be most severely hit by the supply chain disruption caused by climate impacts occurring thousands of miles away.[2]

Firms that successfully manage their ESG supply chain risks may see positive results, such as discovering operational improvements and building resilience into their supply chains. Identifying these types of risks earlier in the process and putting mitigation plans in place can help bolster financial performance.

Benefits of better risk management in supply chains:

- Reduced costs through better risk management
- Better margins from increased labor and operations productivity
- Enhanced continuity of business operations
- Faster adaptation to new regulations and legal requirements
- Increased confidence from investors and stakeholders

Investment managers should be aware of the ESG issues that can arise to provide their clients with the most resilient portfolios. Additionally, they should account for supply chain risks when making capital allocation decisions. Individual investors should evaluate investment managers on their approach to assessing these types of risks and opportunities in their investment portfolios.

Case study: modern slavery in the fashion industry

Modern slavery is an umbrella term for a range of worker exploitation issues, including forced labor, debt bondage, and human trafficking. Instances of modern slavery are prevalent in supply chains that extend into emerging economies, where companies benefit from low labor costs but are exposed to social risks due to lax enforcement of worker protection and regulations.

Modern slavery appears in supply chains across different sectors but is common in fashion and apparel industries that employ a large population of workers—including a significant number of women.

In this case study, let's consider a major U.S.-based fashion brand with a significant consumer-facing presence in the retail marketplace. Manufacturing for its apparel is outsourced to suppliers in different parts of the world, such as Southeast Asia, Central America, and the Caribbean.

Workers in key garment and footwear-producing countries are, on average, receiving just 55% of the pay they need to achieve a decent standard of living.[3]

The labor- and social-related risks the apparel brand faces in its supply chain includes:

Operational risk. While the fashion brand relies on its extended supply chain for cost-saving efficiencies, the company is vulnerable to business disruption if production workers go on strike to protest low wages or poor working conditions, or if infrastructure issues occur because of poor quality and safety issues with buildings—like the 2013 Rana Plaza garment factory collapse in Dhaka, Bangladesh.

Reputational risk. As a consumer-facing business, the company relies on its brand presence and reputation to sustain sales and profitability. However, reports of labor exploitation or poor working conditions with a supplier can be tied back to the company—contributing to a loss of consumer trust, brand reputation, and demand for its products.

Regulatory risk. Legislative efforts at the U.S. federal and state level have sought to punish the use of modern slavery in all industries. One regulatory action on the state level is the California Transparency in Supply Chains Act, which requires firms doing business in the state to disclose the efforts they are taking to eradicate forced labor and human trafficking.[4]

Supply chain risks from an investment manager's perspective

An investment manager should be taking a holistic approach to risk management, which includes these social, regulatory, and governance-related risks in its assessment and valuation processes.

Example: Due diligence questions for identifying ESG-related risks.

THIS ASSESSMENT MAY TRY AND DETERMINE:

- Does the company use suppliers in countries considered high risk for labor exploitation issues?
- Does the company have published policies on human and labor rights?
  – Do these policies apply to all suppliers and subcontractors?
  – Are these policies communicated to all suppliers and subcontractors?
- Does the company have a mechanism to track and monitor risks among suppliers in its supply chains?
- Does the company have a grievance mechanism available for internal and external parties?
- How does the company address flagged complaints or non-compliant matters (e.g., corrective action plans or remediation actions) in its supply chains?
- Does the company have an escalation process and a clear link to its Board's accountability for ESG risks?
- Does the company have contingency plans in place to address disruptions in its supply chain, such as a natural disaster?

How should investors approach ESG risks in supply chains?

Investors who are looking to address ESG-related risks in company supply chains will want to seek out portfolio managers who are thinking about these risks and assessing the potential impact on the company's investment performance. These risks often are not apparent in traditional analysis—unless the impact has already occurred.

Key characteristics of skilled investment managers:

Holistic awareness of risks. When evaluating investment opportunities, the range and scope of risks are likely to differ by sector and by the countries or regions where its suppliers operate. An investment manager should take a holistic approach to evaluate all relevant risk factors, including ESG factors.

Due diligence around supply chain risks. A skilled manager will seek to assess how a company manages its risks and opportunities with its suppliers, including how it manages ESG-related risks. For instance, does a company use its leverage to engage with its suppliers—and, if so, how? Are there incentives or joint projects in place to support suppliers in addressing and reporting risks? These types of reviews can take place by evaluating existing corporate policies and risk management procedures related to environmental, social, and governance factors.

Direct engagement with companies. Focus on understanding each company's strategy through meetings, surveys, and due diligence. This can be useful to see how a company has faced certain challenges, and how they have managed them in the past.

Data collection, measurement, and financial modeling. Ultimately, an investment manager will want to incorporate their evaluation of ESG risks into their overall financial assessment and valuation of the companies they invest in (or intend to invest in).

Supply chains are just one piece of the puzzle

While supply chains are critical to nearly every company's operations, it is far from the only ESG risk. ESG risks are present at every layer of industry—from the extraction of raw materials to production and manufacturing, to shipping and delivery, to sales, marketing, and retail. Investment managers would be well-served to account for ESG risks at every level of their organization—growing their portfolios while helping create a better and more sustainable economy.

For more information on responsible investing, visit us at: newyorklifeinvestments.com.

ABOUT RISK

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Impact investing and/or environmental, social, and governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market.

Further, ESG strategies may rely on certain values-based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviation. Opinions expressed are current opinions as of the date appearing in this material only and are subject to change.

1. The terms ‘responsible investing,’ ‘sustainable investing,’ and ‘ESG investing’ are used interchangeably. They all refer to an investment approach that considers factors typically referred to as environmental, social, and governance factors. This approach may differ depending on materiality, strategy, asset class, or client preferences.
2. Source: Nature, *Global Supply Chains Amplify Economic Costs of Future Extreme Heat Risk*, March 2024.
3. Source: BOF, *Garment Worker Pay at 45% Gap from Living Wage*, Report Finds, February 2022.
4. Source: State of California, *California Transparency in Supply Chains Act*, 2022.

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