# Commodities and Their Place in the Transition Pathway

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**Anu Rajakumar:** The intersection of commodities and environmental, social, and governance or ESG factors present a complex challenge for investors. As broad ideology evolves, investors are becoming more mindful of their impact, including in an asset class like commodities. Some may worry there are drawbacks with the greenification of society or that portfolio construction sacrifices are being made. So how can one of the oldest asset classes mesh with the ethos of today's ESG conscious investor?

And is there a way to thoughtfully approach investing in commodities with an ESG lens? My name is Anu Rajakumar in joining me today from London, are Sarah Peasey, Head of Europe ESG investing, and Hakan Kaya head of commodities to discuss some of the key elements of considering ESG when investing in commodities. Sarah, Hakan, thank you for joining me today.

**Sarah Peasey:** Thanks for having us, Anu.

**Hakan Kaya:** Thanks for having us.

**Anu:** Now, to start off, you each work in different departments within Neuberger Berman, but you've been working together very closely as you consider this intersection between commodities and ESG factors. So Sarah, tell us a little bit about why this topic, again, ESG factors as it relates to commodities investing is important for investors to better understand.

**Sarah:** Yeah, no, absolutely. Anu, I'll kick this off. And we work so closely. We actually sit outside each other's offices here in London. So definitely a crossover in terms of what the teams do, but look, bringing this back to the commodities and the ESG connection, and I think it's a really interesting time for both. And for commodities as an asset class, we've certainly seen a renaissance, I guess, given the backdrop of the persistent inflation that we're seeing from a macro perspective.

However, this has kind of come at a time when, I guess asset allocation is really facing more of a challenge from an ESG perspective. So in terms of being able to demonstrate outcomes alongside the traditional kind of asset allocation decisions that are being made. Now, from a kind of more traditional perspective, commodities have never necessarily been seen as a very ESG-friendly asset class.

But given this increased focused and the fact that we're seeing an interest from regulation propelling ESG forwards, it's an interesting exercise that we thought that we'd undertake to actually seek to understand can commodities as a solution be considered responsible, in some way. And look, we typically think of ESG integration from a physical entity standpoint.

And we can get to grips with the idea of a corporate or a sovereign, for instance, being considered ESG integrated. But when we come at it from a commodity standpoint, it's quite difficult to conceptualize this, especially when we start to bring in the way that we're actually trading commodities as well. And the role in which the mechanism plays around ESG.

So this led us to kind of try to synthesize all of this down and think about it, I guess in a few areas, such as the nature of your exposure to commodities and whether the way that you're actually trading them or speculating on commodities can be considered responsible. And also, can engagement actually play a role in this, and particularly the engagement with the wider, quantity market ecosystem? But Hakan, I'll pass over to you for your thought as well.

**Hakan:** Yeah, definitely, definitely, Sarah. I think, you know, Anu, you see, Sarah and I have overlaps. Of course, we share common goals, We do want to live in a greener world and, we are believing in this green transition. But we also see there's no transition pathway that doesn't involve commodities. One way or another, we will have to invest in these commodities.

So you see we have also these fiduciary responsibilities, Anu. And when you think about them, they are inextricably linked to these, climate considerations. And so this overlap, when you look at this, it's really about the curiosity about bridging this gap. How can we do it? So from traditional ways, the frameworks in stocks and bonds have been there, have been studied, but nothing so far in commodities.

Neither OECD nor United Nations have provided, you know, comprehensive guidance in this field. So we are curious and curious first, you know, we would like to understand, you know, what can we do, you know, that is responsible here? How can we adopt these new investment ideologies? And when we do this, how do we do it properly? And do it honestly without any marketing gimmicks, and how do we integrate these principles in a way that makes logical sense and investment sense too?

**Anu:** That's great. That's a terrific start. Thank you both. So it sounds like you're on this journey. You're trying to navigate how commodities and ESG play together. How can we do this logically without greenwashing? You know, your hearts are in the right place. But with that said, you now, we've seen a variety of sort of receptions globally to ESG investing, and commodities appears to have some specific controversies associated with them when it comes to ESG investing. What are those and how have you gone about addressing some of those?

**Hakan:** Sure, Anu. We have several ESG pushbacks, but the two major ones are about one, of course, the carbon footprint and two, the alleged harm speculative trading can have on society. So, on these emissions, obviously, this is an extractive field and fossil fuels are really in the middle of everything. From production, to transportation, to consumption, so there's really no escape the field emits, right? And the most widely used practice to deal with this issue is either, omit the asset class or divest away from if you have exposures already. So, you know, the idea is there are environmental risks, there are reputational risks, so why bother? Because I think the asset class, it is an inflation hedge, and we saw how effective it was just last year. Stocks and bonds, they went down steeply. But you see commodities they soared.

But besides inflation I think for the next decade or more there's sizable diversifying returns potential, due to still existing unresolved supply under investment issues. Also, you know, you look at it on the demand side, we have several reasons from policy choices to green Capex deployment to now, geopolitical issues. But on this carbon footprint issue, I think the debate is really about who owns it. You know now, if you think about it, let's say an oil futures that will mature in the future. One side of the debate says, as a buyer of the futures contract, you own the carbon footprint. Because at some point you will own that physical oil. But the other side says, you know, the underlying crude oil has not yet been produced. It has not yet been consumed. So entering in a contract today, you know, when you look at it, it didn't force a producer to produce the commodity or produce it substantially, let alone when you look at these futures contracts, as investors, we never take physical ownership. We never take physical delivery at maturity. What we do is we roll these contracts. So, in a sense, the oil associated with our contracts, it may not even be produced at all. So, the carbon footprint ownership is vague. So on top of when you think about physical versus, you know, financial commodity ownership, these financial markets, the volumes in these markets are multiples and multiples of the physical trading volumes. So in a sense, if we believe that futures contracts, have commodity carbon footprint ownership, then we are thinking about the system in which the carbon is substantially over owned. So in a sense, I think that these all refute the idea that the carbon footprint ownership should belong to the derivative investor. So that's one.

The second issue that we face with these societal issues, like there's a belief, you know, commodity speculation, they exaggerate prices, especially food prices, and cause, a social burden, especially on the income constrained. And also, related to the green transition, the idea that investing and buying these commodity features, they will make green enablers, especially metals, very expensive. Again, creating a burden for the society.

And there may be some truth to this, but I think, you know, here we really shouldn't confuse correlation with causation. So especially if you look at those food riots that we've seen in the 2000s, you can easily trace these reasons back to the conditions of those times and the fundamentals, not necessarily speculators you saw in the 2000s we had China coming in, you know, voraciously demanding commodities.

So it's creating this excess demand for grains and food that really created that kind of spikes in food prices at that time. And yes, there was speculative activity, but it was driven, it was not the reason the prices, really spiked up.

I think to the contrary, what I would like to say is, you know, this futures trading, it'll be essential for the economy. Even more so now that we are going into this green transition and, for green transition, Anu, you see these will require large risks and long cycle risks. And really, you know, there should be some sort of like a risk transfer mechanism. And these futures market, they provide it, and only with a transparent, clear forward curve can producers and consumers of this new green economy can make plans and risk hedge around their production or consumption in the future.

So for all those net present value, you know, investors, a commodity forwards curve, a reliable forward curve is *essential* for making, investments today. So in a sense, you know, I think without a deep working healthy derivatives market, it will be very difficult to go through this green transition easily. And I think investors really instead of divesting should become a part of this ecology, provide these pricing signals and liquidity that's needed to kind of like to grease the wheels of this transition.

**Anu:** Great. Thank you, Hakan. That was very thorough. And maybe just to quickly capture some of those thoughts there. One key message that you had was about who owns the footprint, who's the responsible party here? You noted the financial instrument market. The derivatives markets are multiple times larger than the physical markets. And on that note, thinking about kind of ownership, it makes me think a little bit about engagement.

And this topic, engagement stewardship at Neuberger is so important to our firm in that we strongly believe that the dialogue between investors and companies can influence positive behaviors that we believe will drive long-term and sustainable returns for clients. On that note, maybe turning to Sarah, how does this topic of engagement translate in commodities investing? Where, as we mentioned, you know, we're using derivatives, futures, contracts, et cetera, for the implementation of exposures, as opposed to securities like stocks and bonds. How does engagement relate to this asset class?

**Sarah:** Yeah, no, absolutely, Anu. So look, as you said we're an active manager, so engagement is always central to what we do. And we certainly don't think that commodities should be an exception to that rule in any way. Now, ultimately, the last thing that you want to be doing as an asset owner is to be offsetting the positive engagement outcomes that you might be having through your physical exposure, through credit, through equities, with the decisions that you are then taking through your allocation to commodities.

So we think on this basis, engagement needs to be thought of in a more holistic way, especially when you are looking for opportunities to engage with the entire commodity market ecosystem. So this includes exchanges, the producers, the consumers, regulators are increasingly playing a role, and even sovereigns as well. And ultimately, the goal of creating markets that are more sustainably sourced from a commodity standpoint.

And equally, when we're trying to get this wider adoption for the new green alternatives that are starting to come through. So crucially, we have to look beyond the traditional pathways to engagement.

But we also think of this when we are undertaking our engagements in a more traditional sense through our equity or our fixed income exposure. So for instance, a few months ago, we met with the CEO of a very large mining company. And the meeting was attended from representatives across asset classes, but that also included Hakan and myself as well. And we explored a number of different, financially material topics that-that were relevant to this mining company from potential UN violations to water consumption policies, the CapEx that's been spent on water desalination units, which is obviously increasingly important from a mining standpoint.

And even then, the expectations that mining company had on future metals, where the miner is-is doing a lot of work, for instance, on trying to create, greener steel and exploring the use of electric smelting furnaces that are capable of producing steel from iron ore using renewable electricity and hydrogen. So we are able to gain far greater insights from understanding companies that are consuming commodities as well, which can then help to direct our engagement and also our investment decision-making that Hakan is then taking. So I think a lot can be achieved just by simply formulating more of a united front through holistic engagement.

**Anu:** Terrific. Thank you very much, Sarah. You know, you mentioned engagement needs to be holistic and across the ecosystem, including with regulators, which brings me to sort of the next question. You know, there's been a lot of regulation and oversight introduced in recent years, particularly in Europe as it relates to ESG policies and disclosures. Could you address any recent or future policy changes that you think could affect the commodities landscape?

**Sarah:** Yeah, no, absolutely. Look, it's an incredibly exciting time for geeks like myself and Hakan. And as a result of that, it's also a very compelling market backdrop as well. And we are finally getting the signals that we've been wanting for, from policymakers in particular, that gives companies the confidence to transition and ultimately commit the capital. And as a result of this, for sure, 2023 is likely to be a milestone in the extent to which green CapEx is being deployed, which is fantastic when it comes to trying to make progress against these very ambitious goals that we have when it comes to the energy transition.

But putting this into context, so last year, the US, they put a really firm flag in the sand with the announcements around the Inflation Reduction Act. And this is expected to deploy anywhere upwards of $1 trillion of green CapEx in the next decade, if not even higher. And this is coming through the form of subsidies and grants. And this could actually close a significant margin in the emissions gap, which is against the kind of US's current climate target.

So it is going to have a demonstrable impact in what we can achieve from an energy transition standpoint through the US. Now, the US is obviously very pivotal in what we do. The other significant region, which is going to ultimately define the success that we have against these goals of course, is China. And China can certainly not be considered a laggard in any way. All-almost every green technology out there, China has a lead on the rest of the world, whether it's solar panels, whether it's batteries, whether it's electric cars, hydrogen producing-producing, electrolyzers, even over lockdown, we saw copper demand increase.

And this was purely down to the record EV sales that we were seeing across China. So China is making great strides as well, and then, of course, closer to home for us Europe. And it's no secret. Europe has always seen itself as a leader in-in the green transition. And I think it's fair to say it's felt a little bit threatened as well, particularly this year from the US and-and China. And this has naturally led to Europe coming up with their own policies as well. So, a couple of months ago we had the green deal, industrial plan, being finally kind of synthesized down and made public. And I think it's fair to say that the ambitions are pretty lofty in what Europe has set out. A lot of focus has gone into trying to localize production around net-zero technologies. But look, fundamentally for me, Europe is always going to struggle to contend with the likes of the Inflation Reduction Act. And this simply is because Europe is not the United States of Europe. Equally the targets that are embedded into Europe's plans are non-binding. That they're largely aspirational. And these all are very local, state dependent in terms of how the financing all ultimately gets rolled out. And this is different to the Inflation Reduction Act where there's a lot more detail around, the amount of subsidies that will be deployed. So companies as a whole, have an opportunity to guide and direct their financing in a more structured way.

So this potentially is always going to kind of restrict the progress that Europe is going to make. But equally, we're getting lots of headlines where different regions, across Europe are trying to get more of a handle on this. So from a policy perspective, it's incredibly exciting. Now, from a regulation standpoint, again, I'm going to focus in on Europe a bit here, but from a commodity perspective that there's been some really interesting developments this year, some of you may have seen that the European parliament actually voted in favor of a landmark deforestation regulation. And this is ultimately going to prohibit commodities that are produced from deforested land, and these include, cattle, cocoa, coffee, palm oil, rubber, soya, even wood. And these will be restricted from being sold into Europe. And the-these new rules are going to have quite a-an overarching impact on-on importers and-and exporters and there's going to be this new requirement to-to produce due diligence statements, around how your products were ultimately created and-and also where they-they've come from. And again, there are positives to come out of this in terms of policymakers expecting that this is going to have a-a huge impact on protecting hectares of forest, and as naturally also reducing the amount of carbon dioxide, which gets emitted into the atmosphere as well. But we also as investors have to think of the knock-on effect that that's going to have to companies, particularly when it comes to reporting and traceability. Something from a global supply chain perspective, we really struggle with in terms of the level of transparency that we can get. And obviously, corporates are having similar struggles where they have quite deep and complex supply chains. So it is going to be interesting to see how companies adhere to this, and the knock-on effect this will have. But ultimately, that the goal and the ambition is incredibly positive. So it really is all systems go from a policy and regulation standpoint, Anu.

**Anu:** Terrific. And I just for our listeners, I want to know, Sarah really genuinely is excited about all of these policy and regulatory changes that's not scripted at all. She really is super jazzed about what's happening. Is that fair, Sarah?

**Sarah:** Unfortunately, it really is. I hope my friends aren't listening to this.

[laughter]

**Anu:** Sarah, you mentioned China lead in the way with green technologies. And you also mentioned engagement with a company who are focusing on green steel. I want to turn the conversation to hear a little bit more about other innovations within tradable commodities that might be interesting for investors to be aware of. Hakan, anything you'd like to share on that front?

**Hakan:** Yeah, definitely, Anu. You see this, you know, what Sarah said about, you know, exchanges. Exchanges are listening and they're very active in creating these new commodity derivatives new products, right? What used to be a bad commodity like palm oil is now green traceable from Malaysia, that got transformed because of exchange engagement. And so this is how it works, Anu. You see, you know, the-these financial commodities that we trade in, they meet physical commodities in the exchange and, you know, investors or a subset or a collective of them can really influence exchange behavior. So you see, we can enforce exchanges adopting green policies like traceability in their warehouses or derivative contracts they offer. So why don't we have a large deep working green traceable aluminum contract that's essential for the green transition?

Perhaps says in its specification, like, this is extracted in an environmentally conscious way, why not? Why don't we have a well-functioning futures contract on recycled metals, or fair-trade coffee? Most of these, you see, they were unthinkable, you know, a few years before, and now, we can't even talk about these and, you know, impact the exchanges.

And these were unthinkable also because, you know, the commodity producers, they were in a sense too vertically integrated, to need any trading or-or hedging and speculators didn't have any information advantage to join these markets. I think these-these will change with the green transition, with this massive green CapEx deployment hitting the space. And information advantage is now becoming, you know, available with big data potentials, AI potentials these days to- to help us investors, right?

I think, you know, especially related to this green transition, you know, rare metal markets, uranium markets, even water markets. This adoption has to happen. And this can only happen if there's interest and there is willingness to pay the price. And what is the price here? The price is really accepting novelty and liquidity costs that come with it right there. There are success stories of course. For example, you know, carbon futures markets, they have largely succeeded. You see here, there was government involvement, there's corporate involvement, there was exchange involvement, and there is investor buy-in too. So stars really aligned. So for other green enabler successes, again, these four need to understand that trading in the underlying commodity, whatever it is, it is a win-win game.

And I'm optimistic that these tools will-will be available and liquid as we go through time. So, I encourage investors to really understand the logics behind these new indexing tools that are coming into the market these days.

**Anu:** Yes, sure absolutely scrutinizing whether that's the right way to actually play this asset class and with these considerations looking under the hood to make sure you're getting what you're signing up for. Hakan, Sarah, this has been a great conversation so far. As we wrap up this episode, I'd love for each of you to share any final thoughts for our listeners as they consider this important relationship between ESG and commodities. Maybe Sarah, starting with you.

**Sarah:** Yeah, no, no, sure. And look, I appreciate this is perhaps a longer episode for our listeners than they're used to, but I think it just reflects how complex commodities are especially when we are trying to position them from this responsibility context. So I just would encourage our listeners who have this exposure to commodities to think about, not only the underlying commodity itself, but the nature in which the commodity itself is traded as well.

And that mechanism also has to be brought into play when we're- when we're trying to actually answer this question around the-the level of responsibility that's being achieved through your commodities. Equally, it's thinking about this element, which I touched upon through engagement. And we want to achieve engagement across the wider commodity ecosystem. And-and we believe that you can achieve this obviously through the different kind of channels that I mentioned but equally, this can be achieved through your more conventional engagement that you are undertaking as-as well.

And this can be backed by the insights that-that you've gained through your commodity market supply-demand and pricing. We really believe that is a-a more untapped, opportunity that can lead to positive outcomes.

**Hakan:** Yeah, I'll add on top of it, if I may summarize I think, in a practical, commodity action plan for ESG area investors like keeping in mind this-this asset class is interesting. It offers inflation protection; it offers return potential due to supply demand dynamics that can make portfolios robust and reduce volatility. And like in portfolio management I think, you know, ESG should be holistic, divestment in this asset class will not make sense, so avoid divestments. Implement active engagement potentially, you know, elsewhere in your portfolios than stocks and bonds. But, you know, you engage within these derivatives markets to help improve the efficiency of these markets which are absolutely necessary for the green transition to happen without any problem and in an accelerated manner.

And you can implement kind of like responsible strategies, I guess, you know, in a practical sense. Like, for instance, don't take physical delivery when you are investing in futures, avoid physically-backed commodity products that hoards the commodities away from economic use and creates this unnecessary scarcity in the economy. You know, avoid trading strategies that create these kind of like a feedback loops or excess volatility like potentially trend following strategies but instead really be a liquidity provider with a value mindset, right? In other words, promote trading that gives pricing signals and that shapes forward curves that can be used for planning, that can be used for risk management. And wherever you can demand, demand from these exchanges these greener alternatives or green traceable commodities and-and be ready to accept their liquidity costs and be part of this transition.

I think what I would like to finish saying that we are literally not crowning the asset class with an ESG status here but, you know, definitely regarding the future space investments, this may not be as ESG negative as many think, and this may offer potential ways to be implementing these responsible investing ideologies. So last word I guess I should finish with, you know, when implementing ESG, don't forget the ESG right? Energy. Softs. Grains.

**Anu:** [laughs]

**Hakan:** There I said it. Okay. [laughs] I think it's a bad joke but okay, I'll take the blame for this one.

[laughter]

**Anu:** All right. That is a terrific way to end, Hakan. I love that. [laughs] Thank you very much for sharing the new ESG, energy softs and grains. Well, I can't let you both go without a quick bonus question. So, Hakan and Sarah, we're recording this episode right in the beginning of the summer, so I'd like to ask each of you if you could share a favorite memory or tradition from summer from your childhood, as it relates to this very fun and special time of the summer.

**Hakan:** Yeah. Sure. I think, you know, summers are great. I remember from my childhood summer I associate with going to beach and having fun. So it's like, you know, hopefully with these kind of like learning more about these ESGs, I will go have more fun, you know, in the beach with a clear mindset.

**Anu:** Well and, Hakan, just to clarify, these are beaches in Turkey, and if so, which is your favorite beach where you grew up in Turkey?

**Hakan:** Yeah. I like, you know, close to my hometown, there's Çeşme, it's very nice, clear waters. Sandy Beaches. Also kind of like Bodrum and Marmaris. These, I guess I shaped my favorite childhood memories.

**Anu:** Lovely, sounds very, very nice. Sarah what about you?

**Sarah:** Yeah, do you know what? It's so funny 'cause we were literally talking about this coming off in the lift. And Hakan is obviously newer to the UK than I certainly am. We were talking about holidaying in the UK. For me, my childhood was holidaying in the west country. So I used to go to Cornwall and have the fondest memories of getting stuck in traffic jams past Stonehenge. And then eating Cornish pasties in the rain but just blissful memories, very, very happy memories. Um, yeah, that would definitely be mine.

**Anu:** That's fair. I grew up in the UK as well and my favorite thing about summertime was, you know, a softy ice cream with a flake with the chocolate flake inside which we don't get in the US. And that's something that I always fondly remember from the summertime in the UK. Well thank you Sarah and Hakan for joining me today. This has been a fabulous conversation. There's so many takeaways.

Maybe quickly just to summarize a few of them. You know, Hakan, you mentioned the opportunity with commodities. Not just as an inflation hedge and for diversification purposes, but just in summary, you know, the commodities offer a, you said, an unreplaceable investment solution to making portfolios more robust. But when it comes to the integration of ESG, within commodities there's a complexity there that requires really thoughtful and logical thinking behind it. Which clearly the two of you have spent a lot of time thinking about. As you said, for this to take place properly it's going to need holistic engagement and ownership across multiple different players, the exchanges, regulatory-regulators, sovereigns, market participants, really across the entire commodities ecosystem. But as you both said there's a lot of great potential here. Sarah, you mentioned your authentic excitement about everything that could come to follow, so we really look forward to seeing what comes from this intersection of ESG and commodities. Thank you both again.

**Sarah:** Thanks, Anu.

**Hakan:** Thank you.

**Anu:** And to our listeners, if you've enjoyed what you've heard today on *Disruptive Forces*, you can subscribe to the show over via Apple Podcast, Google Podcast or Spotify or you can visit our website www.nb.com/disruptiveforces for previous episodes as well as more information about our firm and offerings.