

A photograph of several wind turbines in a field, silhouetted against a warm, golden sunset sky. The turbines are arranged in a line, receding into the distance. The overall tone is warm and optimistic.

Investor Insights

**Crisis as Catalyst:
Corporate Resiliency
and the Future of ESG**

CORPORATE RESILIENCY AND THE FUTURE OF ESG

George Serafeim, the Charles M. Williams Professor of Business Administration at Harvard Business School (HBS) and a State Street Associates research partner, is the author of ground-breaking analysis of the financial materiality of environmental, social and governance (ESG) issues on corporate performance. In his popular “Reimagining Capitalism” course, he demonstrates to HBS students that ESG issues are important corporate value drivers.

A portrait of George Serafeim, a man with dark hair, wearing a dark suit, white shirt, and patterned tie. He is looking slightly to the right with a neutral expression. The background consists of horizontal wooden slats.

George Serafeim

Charles M. Williams Professor
of Business Administration,
Harvard Business School

Successful companies, he argues, will increasingly embrace the need to articulate a clear organizational purpose and redefine performance to include their impact on society, which should be measured, priced, and included in financial statements. State Street Chairman and CEO Ron O'Hanley recently sat down with George to discuss the pandemic-induced focus on corporate resiliency, the challenges of the economic recovery, and how both will affect the future of ESG.

Ron O'Hanley
Chairman and
Chief Executive Officer,
State Street Corporation



“COVID-19 is a dramatic trigger that should drive a deeper integration of ESG inside an organization’s core business management and strategy.”

George Serafeim

Ron: How do you see the future of ESG and sustainability in a post-COVID-19 world, in which there is intense focus on corporate resiliency but also concern about the costs of economic recovery?

George: As with so many other trends, the crisis has intensified and reinforced the importance of ESG issues. For me, COVID-19 is a dramatic trigger that should drive a deeper integration of ESG inside an organization’s core business management and strategy.

The pandemic cast a bright light on the many institutional vulnerabilities we have in society, and how unprepared we are for some big risks that are going to manifest in non-linear ways. Climate change with its physical effects over time is perhaps the biggest of those risks.

I think the speed with which events unraveled with the coronavirus is an indication of how fast things could also

move at some point with climate change, either because we wake up to the physical risks we are already seeing in the natural environment or because of regulatory action. The question then becomes how fast we will see the repricing of assets and changes in the economy as action is taken.

So that’s the “E” of ESG, but the pandemic also underscored the importance of social or “S” issues, intensifying the social vulnerabilities that existed before the pandemic. COVID-19 has thrown into stark relief the social and economic inequities we’re seeing play out, as different groups demonstrate very different vulnerabilities when it comes to the virus and economic shutdown.

In my view, COVID-19 has escalated ESG issues, making them central to how you actually run a business. They are integral to corporate resiliency and the proper management and governance of an organization.

“The clear message from the data is that investors increasingly want to align with companies that truly understand the importance of proper ESG management when it comes to business resiliency and operations.”

George Serafeim

ESG and Investor Preferences

Ron: You recently tested that hypothesis in **research** you did with State Street Associates, which looked at how the stocks of companies with good ESG practices performed during the market sell-off between late February and late March. Tell us more about that project.

George: The question we asked was whether during a sharp market downturn companies that take action to protect their stakeholders and act responsibly, especially with regard to their employees and supply chains, experience less negative stock performance than their peers. We analyzed the performance of 3,075 global companies representing \$59 trillion in market capitalization between February 20 and March 23 this year, when the S&P 500 experienced a severe drawdown. Our hypothesis was that the market would reward more resilient companies that showed agility in repurposing products and services to provide solutions for the challenges thrown up by the crisis, and to do that you need to manage your employee and supply chain issues responsibly. That in a nutshell is what the data confirmed.

We found that those companies with strong ESG characteristics experienced less negative stock returns during the market collapse, relative to their competitors, and accounting for other variables. Even more striking is that we found that those effects showed up in a stronger way in those industries that were most affected by COVID-19, such as retail, restaurants and airlines. Companies in those industries that were able to maintain employee morale, loyalty and engagement, protect supply chains, and show agility in repurposing operations saw even bigger positive effects in terms of their stock prices declining less than those of their competitors.

The clear message from the data is that investors increasingly want to align with companies that truly understand the importance of proper ESG management when it comes to business resiliency and operations. That, in turn, speaks to the core idea that ESG issues are becoming financially material over time. The important message here is that ESG is no longer just about “feel good” issues. We are talking about ever more important value drivers.

“Articulating a clear purpose and organizing employees and operations around that are the first steps toward building both resiliency and sustainability.”

George Serafeim

The world is changing. Because of innovations, regulations, changes in consumer preferences, and changes in employee preferences, ESG has become financially material, and as a result, those issues are affecting valuations, the cost of capital, operating efficiency and ultimately shareholder value.

Ron: This is an evolving landscape, but you know there are still corporate leaders and investors who push back against ESG, saying it is about feel-good issues or that companies cannot “afford” to focus on sustainability, especially as we face this difficult economic recovery.

Purpose-Driven Companies

George: My own view is that when you hear management saying, “I don’t have time to think about ESG, or the cost might be too high,” this is a fundamental red flag. It means they are looking at ESG through the lens of philanthropy or some other peripheral view, rather than as something that should be core to the purpose and strategy of the organization.

I think when leaders flip that question on its head and start asking: “What is the purpose of this organization and what are we trying

to deliver?” then you align the organization’s strategy, priorities and operations with that core purpose. Then ESG is no longer a cost or a distraction, but it is actually perfectly aligned with what you’re trying to deliver through your operations.

If you look at truly great companies, you find that their leaders have seriously thought about why they are in the marketplace, what their unique competitive advantages are, and how good they are at providing solutions to real challenges in society. Then they align everyone in the organization to this strong and clear purpose so that they can actually execute on their business strategy and deliver value. It is not surprising to me that State Street Global Advisors’ stewardship team asks its portfolio companies to explain how their culture aligns with their business strategy and purpose, as they see the connection to long-term performance.

Defining your purpose and strategy is relevant for any economic environment, and especially if your company or your industry is going through hard times or faces disruption for any number of reasons. Articulating a clear purpose and organizing employees and operations around that are the first steps toward building both resiliency and sustainability.

“Making ESG issues part of business strategy is an excellent way of redressing a disproportionate focus on short-term issues and reorienting toward the long term.”

George Serafeim

Ron: What is your response to company leaders who ask: “If ESG is so important, why don’t analysts ask about it on our quarterly earnings calls?”

George: My first response is to question whether the quarterly earnings call is the right forum for discussing ESG issues, which are inherently longer term than the short-term performance discussed on those calls.

Still, when we analyze the actual content of those calls, it turns out that ESG issues are in fact being discussed. Of course, they aren’t called ESG, but there are discussions around, for example, human capital management or environmental issues. So it is not quite true to say that ESG does not come up.

But a more important question is whether companies want to lead or follow. When it comes to ESG, I think management has to lead and shape the discussion, not leave it up to analysts covering the stock. Management should communicate what is actually important for the organization and shape the discussions with investors, as well as with their board, demonstrating the connections between good ESG practices, corporate resiliency and sustainable value. Making ESG issues part of business strategy

is also an excellent way of redressing a disproportionate focus on short-term issues and reorienting toward the long term.

Finally, I think it is a big misconception to say that if sell-side analysts aren’t asking about ESG, then investors don’t care. Sell-side analysts are intermediaries, and the underlying investors are actually the buy side. Still, in too many cases, management communicates more with the sell side than with the buy side.

Ron: How have large asset managers like State Street and large asset owners like big pension funds changed that dynamic?

George: There has been a huge inflection point as a result of your engagement, which was a big part of my theory of change. I wrote an [article](#) a few years ago called, “Investors as Stewards of the Commons,” in which I pointed to the important role that large index investors like State Street have to play. As you become more vocal and ask for disclosure around ESG issues, you are also asking companies for good management of those issues. You have the capacity to engage because of your size and exposure to the entire market. By definition, you are also long-term investors with a vested interest in promoting sustainable performance on behalf of your asset owner clients.

“If you believe in the power of markets, then we need to come up with a fix because we have a classic externality problem in the form of carbon emissions that is undermining market efficiency.”

George Serafeim

Regulatory Drivers

Ron: We know there is still much more work to be done on the ESG data front. What is your view of the regulatory front? Thus far European policymakers have committed to linking economic recovery packages to their sustainability goals and are moving ahead with their disclosure standards, albeit with some pandemic-related delays. Can the European Union (EU) become the global ESG standard-setter without the US or China?

George: So many ESG issues like climate change are global challenges that require global coordination. But I do think the EU is a big enough marketplace that, if they move ahead with some of those initiatives, the world will move with them. A good example of that is the EU's directive for mandatory disclosure of non-financial information, meaning ESG information. Once the European Union acts, that will put pressure on many other jurisdictions to harmonize, because the last thing anyone wants is to create uneven playing fields. I expect that the US and China will want a seat at the table, because these EU rules will affect US and Chinese companies as well.

Ron: What is your view on getting a more comprehensive carbon pricing framework in the near future?

George: I think the idea of introducing a carbon tax in Europe to incentivize the diffusion of decarbonization across jurisdictions is promising. I also see that catastrophic weather events are persuading more people in the US that something needs to be done about climate change. Regardless of your political party affiliation, if you believe in the power of markets, then we need to come up with a fix because we have a classic externality problem in the form of carbon emissions that is undermining market efficiency. Measuring and pricing that externality would make markets perform much better.

But it's important to understand that even if we were to introduce a global carbon pricing program today, it would take far too much time for all necessary technological innovations to be widely adopted. I just published a [paper](#) on climate change with my colleague, Rebecca Henderson, with whom I teach the “Reimagining Capitalism”

“So what really gives me hope about the future of ESG is the combination of the evidence of data, the enthusiasm of the young generation that wants to build a better world, and the leadership of those corporate executives who see the long-term value opportunities inherent in building sustainable and inclusive organizations.”

George Serafeim

course at Harvard Business School. We argue that while a carbon price is necessary, it likely will not be sufficient to get us to a 1.5 degree world scenario because research shows us that the diffusion and adoption of innovations like that would take too long. Instead, we believe that, in addition to a carbon tax, if more companies became purpose-driven and committed themselves to a sustainable future, we could accelerate the reduction in greenhouse gas emissions and the development of innovations needed for the climate challenge much more quickly and effectively.

Ron: What gives you hope about the future?

George: My hope is that the momentum we have built on the business side will continue. As more companies with strong ESG

characteristics and practices become successful, it will help redefine what drives business success. There is a tremendous opportunity for changing behaviors by observing successful outcomes. As the data documents those successes, business leaders will pay more attention to what is actually creating value in this environment. So what really gives me hope about the future of ESG is the combination of the evidence of data, the enthusiasm of the young generation that wants to build a better world, and the leadership of those corporate executives who see the long-term value opportunities inherent in building sustainable and inclusive organizations.

For more information, go to

www.statestreet.com/ideas

STATE STREET®

State Street Corporation
One Lincoln Street, Boston, MA 02111

www.statestreet.com

Important Information

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such. Views and opinions are subject to change at any time based on market and other conditions. The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without State Street's express written consent.

This document and information provided herein is for marketing and/or informational purposes only, it does not take into account any prospects or client's particular investment or other financial objectives or strategies nor any prospect or client's legal, regulatory, tax or accounting status, nor does it purport to be comprehensive nor intended to replace the exercise of a prospect or client's own careful independent review regarding any corresponding investment or other financial decision.

This document and information provided herein does not constitute investment, legal, regulatory, tax or accounting advice and is not a solicitation to buy or sell securities nor to enter into any transaction, nor is it intended to constitute any binding contractual arrangement or

commitment by State Street to provide securities services nor any other financial services. Any information provided has been obtained from sources believed to be reliable at the time of publication, nonetheless, we cannot guarantee nor do we make any representation or warranty as to their accuracy and you should not place any reliance on such information. This document and any comments and statements made herein do not necessarily reflect those of State Street, its subsidiaries or its affiliates. State Street hereby disclaims all liability, whether arising in contract, tort or otherwise, for any losses, liabilities, damages, expenses or costs arising, either direct or consequential, from or in connection with the use of or any reliance place upon any information provided.

This document and information provided herein is not intended for retail clients, nor for distribution to, and may not be relied upon by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to applicable law or regulation.

©2020 State Street Corporation
All Rights Reserved
3121069.1.1.GBL.RTL
Expiration date: 6/15/2021