Momentum Will Carry ESG Investing Far Beyond the Pandemic

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The ESG investing story of 2020 has centered around the COVID-19 pandemic, but we believe that 2021 could be the transition year for concerted global action to tackle climate change and other environmental and social challenges. ESG investing is gaining momentum that will likely prevail long after the pandemic subsides.

ESG Has Outperformed in 2020

After several years of slow but steady growth, investor flows into environmental, social, and governance investments have increased significantly in the months following the COVID-19 outbreak. According to Morningstar,[1] over $80 billion flowed into global sustainable funds in the third quarter of 2020, an increase of 14% on the second quarter. Assets under management climbed 19% to a fresh high of $1.23 trillion. The bulk of flows came from European investors, but net inflows were also seen in the US, Canada, Australia and New Zealand, Japan, and the rest of Asia. Notably, the European sustainable fund market grew 10% between the second and third quarters, compared with only a 1.6% increase in overall European fund universe assets.[2]

This is all for good reason. Investors have been attracted to the resilience of ESG stocks during the pandemic. In a recent study, Fidelity found that stocks and bonds with higher ESG ratings outperformed those with weaker ratings in 2020.[3] Indeed, over the course of the year up to November 4, the MSCI ACWI ESG Universal index had an excess return of 1.6% against the standard MSCI index.[4] And Bank of America has found that higher-ranked ESG companies in the United States, Europe, and Asia have seen lower downward earnings revisions for 2020 and 2021 expectations than lower-ranked companies.[5]

The reasons for the robust performance of ESG funds can vary and need to be evaluated on a case-by-case basis. In aggregate, however, the extraordinary year of 2020 supports our main view: Companies with superior corporate governance and better environmental and social practices than their peers display greater resilience and preserve long-term value more effectively during times of market stress.

Government Policy Will Prioritize Climate Action

The global economic slowdown caused by the pandemic has led to a re-evaluation of the importance of environmental and social challenges and the role governments should play in tackling those challenges.

Governments around the world have enacted huge fiscal stimulus measures to boost their economies since the start of the pandemic. As governments play a greater role in corporate and societal affairs, we expect enhanced efforts to incorporate sustainability into the political agenda. In particular, regulatory pressure to limit carbon emissions will tighten in order to meet the Paris Agreement goals of carbon neutrality by 2050. Increasing adoption of carbon-pricing initiatives will be a central lever for decarbonization, particularly in China and Europe.

We expect renewable energy to play a central role in the global economic recovery post-pandemic. China, India, and the European Union continue to roll out large solar and wind projects. The EU is also investing heavily in sustainable rail infrastructure, as well as installing electric vehicle (EV) charging points and subsidizing EV purchases on a large scale.

Perhaps the single most significant development in global efforts to tackle climate change this year has been the election of Joe Biden as the next President of the United States.[6] This represents a pivotal shift in the political climate of the world's largest aggregate carbon emitter.

President-Elect Biden promises a $2 trillion climate package focused on modernizing infrastructure, creating new jobs, and boosting manufacturing and adoption of renewable energy, with the aim of cutting carbon and methane emissions, and ultimately achieving carbon neutrality by 2050. He has also recently stated his intention for the United States to rejoin the Paris Agreement. The signs are promising. With Democrats and Republicans battling for control of the Senate until January 2021, however, it's unclear whether Biden will have an obstacle-free path to push his ambitious agenda through. Even so, we believe that the general tone of the discussion certainly will change in the new administration, which will support further adoption of ESG practices.

Biden will also likely oversee a review of key posts in the Securities and Exchange Commission, Department of Labor, Federal Reserve, and other US government bodies, which could augur a shift in the perception and adoption of ESG investing. For the first time, the Fed has identified climate change as a risk to the stability of the US financial system in its latest financial stability report.[7]

Finally, a Biden presidency may be influential in creating global agreement on countries' nationally determined contributions to meet the Paris Agreement goals at the 2021 United Nations Climate Change Conference (COP26) in November 2021.

The March from Shareholder to Stakeholder Capitalism

Companies that have received government funding to stay afloat are now operating with a new social contract — a "social licence to operate." The traditional paradigm of shareholder primacy is shifting toward one in which companies must be seen to act in the best interests of all stakeholders. Company executives are increasingly expected to consider the impact of their decisions not just on their shareholders but also on customers, employees, partners, suppliers, society, and the environment. We expect this paradigm shift toward purpose-driven companies, driven by environmental and social well-being, to gather pace in the coming months.

Dividend policy provides an interesting example of changing corporate attitudes. In a typical slowdown, companies protect dividends payments to send a positive signal to shareholders. Indeed, many companies scale back investments and cut costs in order to preserve the cash flows needed to pay steady or increasing dividends.

The increasing focus on stakeholder capitalism, however, is leading investors to be more supportive of companies using cash flow to invest in improving working conditions and nurturing customer and supplier relationships during challenging economic periods. It's noteworthy to observe the extent to which the oil majors, including BP and Shell, have cut dividends and reoriented their corporate strategy to align with the transition to the low-carbon economy.

This trend reflects the growing importance investors are placing on a holistic approach to investment that considers ESG, and particularly social issues, on a par with financial indicators. Companies will increasingly need to improve transparency and show evidence for how they are accommodating the needs of all their stakeholders.

For companies to move the markets away from "short-termism" and focus on long-term value creation and stakeholder engagement, the volume, quality, and prominence of ESG-related information and disclosures shared on their quarterly earnings calls must increase. The lack of focus on ESG plays a direct role in driving short-term thinking, myopic decision-making, and incomplete assessments of the sources of value creation, as supported by recent research.[8] To that end, we did see some changes in 2020: ESG mentions on S&P 500 earnings calls dropped at the beginning of the year, only to double back up in the second quarter of 2020 — a trend that we believe will continue.[9]

Beyond the Pandemic

In the wake of the pandemic, we are seeing a renewed emphasis from governments and companies on addressing major environmental and social challenges. This may be a boon to efforts to slow climate change, which is perhaps the gravest long-term threat that humanity faces. We believe climate change will be increasingly viewed as a slow-burning pandemic requiring urgent action.[10]

Investors will play a critical role in the transition to a more sustainable, equitable, and low-carbon world. We expect the momentum for investor acceptance of the materiality of ESG risks and opportunities to only increase. In 2021 and beyond, ESG investing will gather momentum and attention at a rapid pace.

Endnotes

1 https://esgclarity.com/unprecedented-number-of-new-funds-drives-european-sustainable-flows-to-fresh-high/

2 https://morningstar.co.uk/uk/news/206906/esg-funds-assets-hit-%C2%A3800-billion.aspx

3 https://fidelityinstitutional.com/en-gb/articles/pages/putting-sustainability-to-the-test-esg-outperformance-903013

4 https://msci.com/end-of-day-data-search

5 https://michiganfoundations.org/sites/default/files/ESG%20Matters%203.25.2020.pdf

6 Assuming President Trump's legal challenges are unsuccessful.

7 https://federalreserve.gov/publications/files/financial-stability-report-20201109.pdf

8 https://stern.nyu.edu/experience-stern/about/departments-centers-initiatives/centers-of-research/center-sustainable-business/research/research-initiatives/integrating-esg-quarterly-earnings-call

9 https://insight.factset.com/100-increase-in-sp-500-companies-citing-esg-on-earnings-calls-in-q2-vs.-q1-1

10 https://federalreserve.gov/publications/files/financial-stability-report-20201109.pdf

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