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COVID-19 and ESG: Four Dimensions

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The COVID-19 pandemic is having devasting effects on almost all areas of our lives, both professional and private. It shows us how vulnerable we are as individuals and as a society. It also highlights how globally interconnected we are, especially in terms of commerce and trade.

Where will this lead us when it comes to the value and adoption of ESG?

When looking at percentage growth rates, ESG investments are amongst the fastest growing areas in finance. But in absolute terms they are still not mainstream. So, the question arises whether the current pandemic will lead to a further acceleration of this trend or slow it down.

Early results suggest that the effect on sentiment around ESG adoption will be positive with two thirds of participants in a recent study conducted by Responsible Investor saying that the coronavirus pandemic could prove a tipping point for ESG.[1] This could be the boost that ESG investing needs to become truly mainstream.

However, some commentators doubt this, believing that ESG is a “nice to have”, which companies and investors will not have the luxury to focus on in a crisis like this, and hence it will be de-prioritised.

This paper sheds light on four important dimensions on how the COVID-19 pandemic can influence ESG adoption, namely:

- The significance of ESG criteria
- Impact on climate initiatives
- ESG performance
- Stewardship and engagement

Dimension 1: The Significance of ESG Criteria

Although maybe not obvious at first sight, the crisis uncovers the importance of key ESG performance indicators for long-term value creation.

The “S”, or social part, has often been perceived as rather vague and deemed insignificant by critics. This crisis proves this is mistaken. Social aspects are important in the equity space and also in fixed income, where “S” has started to manifest in the creation of various kinds of “social bonds” to combat the effects of the pandemic.

A company’s resilience and contingency planning, especially in times of crisis, are crucial for its long-term performance. Hence, investors will have a heightened focus on these governance (“G”) areas.

When considering the framework of the Sustainability Accounting Standards Board (SASB), the following material issues specific to COVID-19 can be identified:

Access & Affordability The category addresses a company’s ability to ensure broad access to its products and services, specifically in the context of underserved markets and/or population groups. It includes the management of issues related to universal needs, such as the accessibility and affordability of health care, financial services, utilities, education, and telecommunications. Example: Drug pricing.

Labour Practices The category addresses the company’s ability to uphold commonly accepted labour standards in the workplace. It also includes minimum wage policies and provision of benefits, which may influence how a workforce is attracted, retained, and motivated.
Example: Flexible working hours, working from home, shift work.

Employee Health & Safety The category addresses a company’s ability to create and maintain a safe and healthy workplace environment that is free of injuries, fatalities, and illness (both chronic and acute). It is traditionally accomplished through implementing safety management plans, developing training requirements for employees and contractors, and conducting regular audits of their own practices as well as those of their subcontractors. The category further captures how companies ensure physical and mental health of workforce through technology, training, corporate culture, regulatory compliance, monitoring and testing, and personal protective equipment.
Example: Maintain safe workplace during crisis, contactless delivery.

Supply Chain Management The category addresses management of environmental, social, and governance (ESG) risks within a company's supply chain. It addresses issues associated with environmental and social externalities created by suppliers through their operational activities. Such issues include, but are not limited to, environmental responsibility, human rights, labour practices, and ethics and corruption. Management may involve screening, selection, monitoring, and engagement with suppliers on their environmental and social impacts.
Example: Externalities created by suppliers through their operational activities.

Competitive Behaviour The category covers social issues associated with existence of monopolies, which may include, but are not limited to, excessive prices, poor quality of service, and inefficiencies. It addresses a company's management of legal and social expectation around monopolistic and anti-competitive practices, including issues related to bargaining power, collusion, price fixing or manipulation, and protection of patents and intellectual property (IP).
Example: Avoidance of monopolistic behavior.

Critical Incident Management The category addresses the company's use of management systems and scenario planning to identify, understand, and prevent or minimise the occurrence of low-probability, high-impact accidents and emergencies with significant potential environmental and social externalities. It relates to the culture of safety at a company, its relevant safety management systems and technological controls, the potential human, environmental, and social implications of such events occurring, and the long-term effects to an organisation, its workers, and society should these events occur.
Example: Remote work infrastructure.

Source: SASB and State Street Global Advisors.

This shows the significance of financially material ESG issues for a company's success. Hence, the added value of integrating this data in portfolio structures and investment decision making becomes evident.

To address this, State Street Global Advisors developed R-Factor™, an ESG scoring system that leverages the SASB materiality map and measures the performance of a company's business operations and governance as it relates to financially material ESG issues facing the company's industry. We now incorporate this in investment solutions and reporting, as well as our stewardship programme.

However, the above mentioned material issues are all in the "S" and "G" space. Does that mean, that the "E" pillar in general, and climate related measures in particular, will become second-order priorities?

Dimension 2: Impact on Climate Initiatives

Within the ESG space, climate change and its associated environmental and economic risks have been the dominant topic in recent times. But as the COVID-19 pandemic is not an environmental crisis where does this leave us? Will this focus shift?

The UK government recently announced the postponement of the 2020 United Nations Climate Change Conference in Glasgow (COP26) to 2021. Also, the European Fund and Asset Management Association (EFAMA) — one of the key players in the context of the EU action plan on sustainable finance — also announced that progress will be delayed.

Postponement of conferences and the amendment of timelines from industry associations will likely lead to a postponement of critical decisions needed to further support important initiatives to fight climate change.

More important, however, is whether this will also lead to a de-prioritisation from both private and public funds allocating towards projects and R&D spending needed for the transition to a low-carbon economy. On one hand the United States plans to spend US$2 trillion, or 10% of GDP, for economic stimulus to fight the negative impacts on the economy. On the other, albeit less obvious, is the need to spend US$2.4 trillion per year globally over the next decade to keep temperatures within 1.5°C above pre-industrial levels. So, one could ask the question if it is a matter of prioritisation and mutual exclusivity. However, this would be a dangerous conclusion.

Climate change can be described as a slow-moving, or rather, "slow-burning" pandemic. The long-term impact of climate change, both from an environmental, social and economic perspective could ultimately be even higher than that of the current pandemic.

During this crisis, the importance of innovation and science becomes very apparent as well as the need for cross-border collaboration. All aspects are needed to effectively fight climate change.

Hence, while some climate-related initiatives might be postponed in the short-term, awareness of the significance of climate change should increase, which could then lend more support and funding to tackle climate change in the medium and long-term.

Dimension 3: ESG Performance

The discussion around ESG performance is as old as ESG data exists. Many investors view the incorporation of ESG data, especially in the "best-in-class" space (where companies with better ESG ratings are systematically overweighted), as having a negative effect on portfolio risk-return profiles. One reason is that some investors still view the integration of ESG parameters as a constraint with negative effects.

However, a recent study by Morningstar[2] concludes that there is "no evidence that investors need to sacrifice returns when they invest in good ESG companies globally compared with bad ESG stocks."

Indeed, several studies have identified a positive link between ESG integration and various measures of corporate performance. In a well-known meta-study[3] of over 2,000 academic studies, 90% showed a non-negative relationship between incorporation of ESG criteria and corporate financial performance, and 63% identified a positive link.

Harvard University[4] has found that firms with good performance on material sustainability issues — as defined by SASB — significantly outperformed firms with poor performance on these issues.

More important in the current challenging environment is how ESG funds perform compared to traditional funds during market sell-offs. There have been few opportunities to test this given that the growth of ESG investing in recent years has occurred against a relatively benign market backdrop. We would expect that ESG integration would help reduce portfolio risk by investing in higher-quality issuers with stronger balance sheets, governance and risk management practices and labour standards. Does the data on the current downturn support this?

HSBC[5] measured the performance of shares in 613 public companies globally valued at more than $500 million, where climate solutions generate at least 10% of revenues. HSBC also looked at the 140 shares with the highest ESG scores and values above the global average. The study ran from 10 December 2019 to 23 March 2020, and from 24 February 2020 to 23 March 2020, the latter period being when market volatility spiked. The climate-focused stocks outperformed others by 7.6% from December and by 3% from February. The high ESG-scoring shares beat others by about 7% for both periods.

In another study, Morningstar[6] found that sustainable and ESG equity indices outperformed conventional indices in the Global, Europe and US Large-Cap categories in the month to 20 March 2020. These studies suggest that portfolios with ESG integration provide good downside protection when markets are struggling.

In the fixed income space, specifically in emerging market debt, the ESG equivalents of the broad market indices showed an outperformance during March 2020.[7]

Additionally, flows with regard to ESG funds that provide broad market exposure are much more robust vis à vis conventional counterparts.[8]

However, it's important to emphasise that we are still in the early stages of the COVID-19 pandemic and given the limited data these findings should be treated with caution. We will continue to monitor the performance and risk characteristics of ESG funds as the pandemic evolves.

Dimension 4: Stewardship and Engagement

In a crisis like this, engagement with companies will inevitably shift to more immediate ESG issues such as employee health, serving and protecting customers and ensuring the overall safety of supply chains. Additionally, companies are forced to focus on short-term financial resiliency. For instance, many companies are considering reducing their capital spending, share buybacks, dividend payments and expenses.

So, companies will need to balance the (sometimes competing) needs of employees, customers, shareholders, regulators and the broader community, which will differ by company, industry, and region. Hence, engagement practices must be mindful of these developments.

However, that does not mean that shareholders should give companies "carte blanche" to ignore ESG issues as they will likely be vital contributors to long-term value creation.

With this in mind, shareholders should encourage companies to:

- Refrain from undertaking undue risks that are beneficial in the short-term but harm longer-term financial stability and the sustainability of the business model.

- Communicate to investors COVID-19's short- and medium-term potential impact to the business, overall operations and supply chains, including management preparedness and scenario-planning and analysis.

- Articulate how COVID-19 might impact or influence their approach to material ESG issues as part of their long-term business strategy.

Additionally, the pandemic hinders companies' ability to hold in-person annual general shareholder meetings (AGMs), which are important means for investors to raise their voice. Hence, companies will have to shift to a virtual model. When conducting an annual meeting virtually, companies will be expected to preserve all the rights and opportunities afforded to shareholders through a physical meeting. Most importantly, shareholders should be able to have active and robust interactions with management and the board at appropriate times.

Additionally, the focus on financially material ESG issues, and how these issues can be adopted in engagement activities should increase.

Conclusion

The COVID-19 pandemic provides a basis for investors to examine the importance of financially material ESG criteria in their portfolios.

Although some climate-related initiatives will likely be postponed, the short-term lack of progress will be more than counteracted by the realisation that climate change is comparable to a slow-moving pandemic with equal, if not worse, effects in the medium and long-term.

Regarding performance, there is growing evidence of a positive effect of the integration of ESG criteria in portfolio strategies, including periods of market sell-offs.

Prudent engagement and stewardship practices are particularly crucial in these challenging times. While shareholders should be mindful of the short-term impacts of the crisis, the focus on material ESG issues as part of company engagement strategies should not be forgotten.

Hence, although some disruptions are inevitable, the longer-term importance of ESG issues to companies remains intact. As a result, the crisis could well heighten interest and adoption in ESG investing.

Endnotes

1 'RI Survey: Pandemic could be tipping point for ESG' (2020).

2 'Better Minus Worse: Evaluating ESG Effects on Risk and Return', Patrick Wang and Madison Sargis (2020).

3 'ESG and financial performance: aggregated evidence from more than 2000 empirical studies', Gunnar Friede, Timo Busch & Alexander Bassen (2015).

4 'Corporate Sustainability: First Evidence on Materiality', Mozaffar Khan, George Serafeim, and Aaron Yoon, Harvard University (2015).

5 'ESG stocks did best in COVID-19 slump', Ashim Paun (2020).

6 'How ESG ETFs Have Performed in the Sell-Off', Briegel Leitao (2020).

7 State Street Global Advisors, Bloomberg (2020).

8 'Bull market phenomenon? Quite the contrary', Subramanian et al (2020).

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $3.12 trillion* under our care.

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