

If a key investment story of 2020 is COVID-19 and the disconnect between manic markets and a traumatized global economy, a less dramatic but financially urgent sequel to that story may focus on heightened market volatility and the search for more resilient investment solutions. Margaret Childe, Head of ESG Research and Integration (Canada), explains how environmental, social, and governance (ESG) investing has emerged as a key method for pursuing such portfolio resilience, particularly in the context of proliferating economic and systemic social risks.

## ESG portfolio resilience to social dislocations

### ESG investing and the pandemic

At the onset of this year's pandemic-driven volatility, signals of ESG-related strength were widely noted, both at the company level and in ESG-focused equity investment strategies. For example, a Harvard Business School working paper released in April documented how companies that the public perceived as behaving more responsibly during the March downturn had less-negative stock returns than their competitors.<sup>1</sup> And in a widely cited U.S. mutual fund industry study, fund rating agency Morningstar remarked that "4 times more sustainable funds finished in the best quartile than in the worst quartile of their categories" during the first quarter (Chart 1).<sup>2</sup>

What was the key to this resilience? One reason is a widespread energy sector underweight among ESG investment approaches. As COVID-19 dealt a serious blow to the near-term prospects for global economic growth, that helped trigger an oil price collapse and major volatility across the energy sector. A structural view against the future prospects of traditional energy companies, it appeared, helped the performance of a broad swath of ESG funds versus their traditionally managed peers.<sup>3</sup>

Beyond the cautious sector view, the *Wall Street Journal* noted in late March that ESG factors, particularly social factors, could become more important at the corporate level as investor interest in

companies' approach to human capital management grew more urgent.<sup>4</sup> And as Morningstar's Head of Sustainability Research for the Americas John Hale declared, ESG strategies appeared to be notably consistent outperformers because they tended to pursue the "quality companies of the 21st Century," with a focus on "selecting stocks with better ESG credentials."<sup>5</sup>

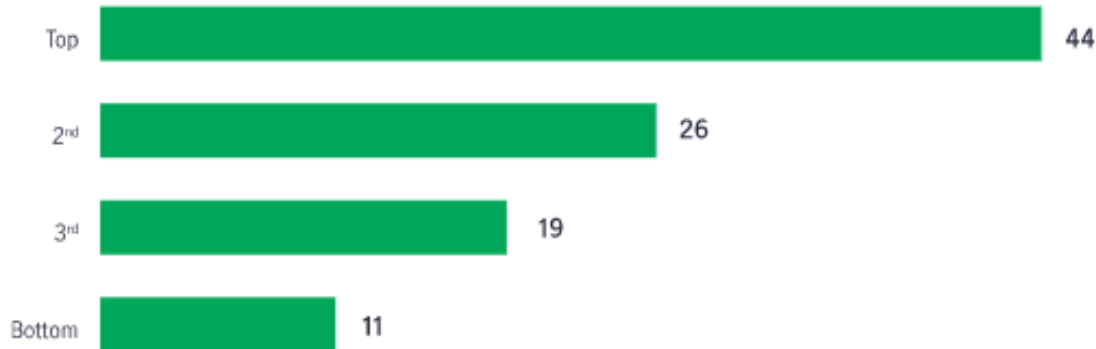
In this moment, ESG factors showed their close alliance—even an identity—with the most operative contemporary definitions of quality. Notably, though, this isn't quality conceived as a history of profitability, but quality associated with a mix of quantitative and qualitative signals of *sustainability*, particularly factors that have often been called nonfinancial, intangible, or *pre*financial.

In times of crisis, the *pre*financial costs can become financial—sometimes, materially so—flipping the script of materiality and displacing other factors that might formerly have been deemed to have a greater impact on a company's bottom line. One of the questions we face now concerns whether this reshuffling of factors on the basis of their materiality requires a tactical or a more strategic shift in investment approach.

## Chart 1

### Sustainable equity funds performed well during the crisis

Q1 2020 return rank % by Morningstar category quintile



Source: Morningstar, as of 3/31/20. Based on a comparison of the first-quarter returns of 206 sustainable equity open-end and exchange-traded funds available in the United States with those of their respective categories, sustainable funds performed better on a relative basis. For illustrative purposes only. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Past performance does not guarantee future results.

## The pandemic and the proliferation of social risks

As the pandemic has progressed, it appears that companies with a stronger ESG proposition seemed better prepared to weather the economic storm that no one projected would happen<sup>6</sup>, not to mention the social unrest that soon followed. Surfacing a range of systemic social risks, the pandemic has underscored the fragility of economic structures in relation to social factors.

According to some observers, ESG strategies have maintained an edge through 2020's market dislocations because they've taken a long view on what counts as a sustainable investment across sectors. Banks and other institutions that formerly downplayed the significance of ESG investing have consequently developed a keen interest in sustainable investment characteristics.<sup>7</sup> We think this set of key characteristics is a dynamic but finite set of interrelated ESG factors (Chart 2).

An ESG strategy's potential for outperformance, moreover, rests on its practice of modeling different scenarios of deterioration or strength. That can mean anticipating the consequences for corporate health in the context of varying climate scenarios or the degree of positive or negative momentum due to changes in

social conditions. While the social factors at issue in the pandemic have varied by region and timeframe, the social factors we've observed as being the most material for the greatest number of companies include health and safety, labor relations, and respect for the community.

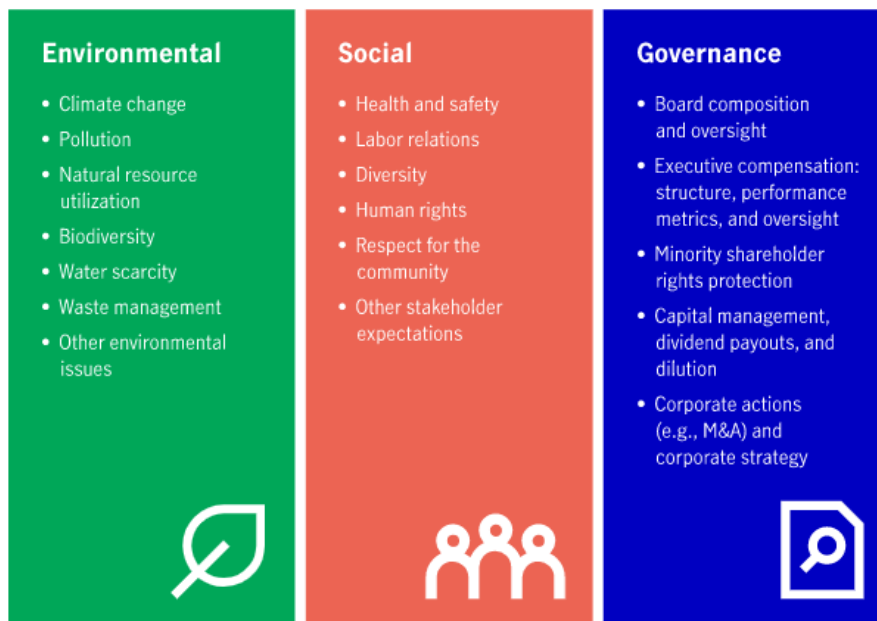
### ***Health and safety: public health structures under pressure***

Health and safety are at the center of the pandemic's swirl of uncertainty. In March, market participants of all levels of sophistication suddenly found themselves grappling with personal and community-focused health questions that could have profound consequences for their lives, livelihoods, and investment portfolios:

- Is it safe for anyone to go to work or for my children to go to school? How long will my family need to shelter in place?
- Is our public health system equipped to handle the pandemic or will it be pushed past its breaking point?
- Would resources aimed at finding a cure be allocated in a way that hastened the development

## Chart 2

Some ESG factors that we believe are most relevant to our investments



For illustrative purposes only.

of truly effective treatments for the general population or shareholder- and insider-focused profits?

There were and continue to be no guarantees that the resolution to these health and safety questions will be positive in the short to medium term, neither for the global population nor for the global economy. Faced with such staggering uncertainty, traditional asset managers and asset owners were all equally in the dark about what they could reasonably expect from their portfolios in the way of risk/adjusted returns. But because of their focus on systemic risks, ESG-strategies can be more aware of the materiality of social risks for different companies, industries, and economically interdependent regions exposed to outbreaks.

### ***Labor relations: a major stress test for companies in hard-hit areas***

At no time since the Great Depression did so many people lose their jobs or have the safety of their employment put into doubt so quickly. Consequently,

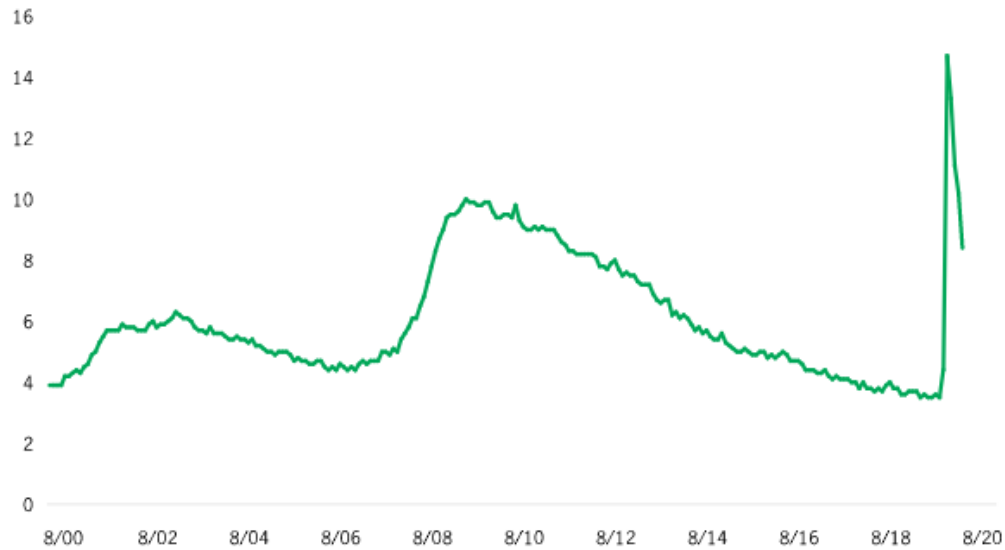
labor relations swiftly became a flash point for companies across the capitalization spectrum:

- How steadfast could companies be in treating employees empathetically—putting their health and safety, not to mention their jobs, above corporate profits? What if the crisis wears on into 2021 and beyond?
- Would companies be able to create safe workspaces for their employees? At what cost?
- Were companies fully aware that their behavior during the crisis might define their future ability to retain talent and customer loyalty?

**Chart 3**

**U.S. civilian unemployment rate (%)**

August 2000–August 2020



Source: U.S. Bureau of Labor Statistics, as of 8/31/20.

In the early stages of the first wave of the pandemic, charts showing unemployment data registered an implausibly sharp spike. Within a matter of weeks, U.S. unemployment rose above 14%, indicating tens of millions of people had lost their jobs. While data was more mixed in European countries, emerging economies also faced a severe employment shock.<sup>8</sup> What could companies and sovereigns realistically do to protect the unemployed and the still employed but quickly overextended essential workers? How companies treat their employees in the context of once-in-a-generation financial difficulty is perhaps the ultimate stress test measuring the relative strength of the social factor across companies, industries, and sectors (Chart 3).

**Respect for the community: positive catalyst for change?**

Respect for the community has become another flash point of risk and opportunity for many companies since the onset of the crisis:

- Would companies take pains to shift their operations smoothly—for example, by implementing business continuity plans or by putting certain operations on hold until a time of relative safety?

- If a company operated in the presence of the general public, did it respect pandemic-mitigation measures or treat these in a more cavalier manner?
- Did companies donate resources to help the broader community? Whether that meant donating PPE gear or converting manufacturing capacity to build ventilators, produce hand sanitizer, and so on.
- In what ways have companies pledged to change for the long term, particularly with respect to how they see themselves and their operations having an impact on the communities in which they operate?

Many companies have shown a willingness to tread a path toward social change. Nowhere is this more evident than in the United States, where the pandemic has exacerbated tensions in the country’s ongoing reckoning over its history of racial injustice. Where companies stand on the relevant issues has more than occasionally had an impact on their business, and—on the hopeful side—these positions may become catalysts for improved results in U.S. board diversity, gender equality, and equitable compensation structures that favor broad stakeholder interests.

## **Sustainable investing is resilient investing**

For ESG investors, the central focus is on *sustainability*, a condition of resiliency represented in company fundamentals and management effectiveness at managing material risks, which, in aggregate, gives companies a better chance of thriving in the future. As it was recently put in *Responsible Investor*, the measure of company's sustainability comes down to "how resilient and agile [they are] in handling many stakeholders, global uncertainties, shocks and disruptions—regardless of whether these are caused by a pandemic, social unrest, or an environmental emergency."<sup>9</sup>

Qualitative, prefinancial factors are accepted by ESG strategies as potential drivers of future business strength and weakness. That may be one reason why momentum continues to gather behind ESG strategies, as investors increasingly look to see whether a company has the strategic vision and capabilities to achieve and maintain strong ESG performance—in other words, long-term resiliency and the ability to manage tail risks.

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