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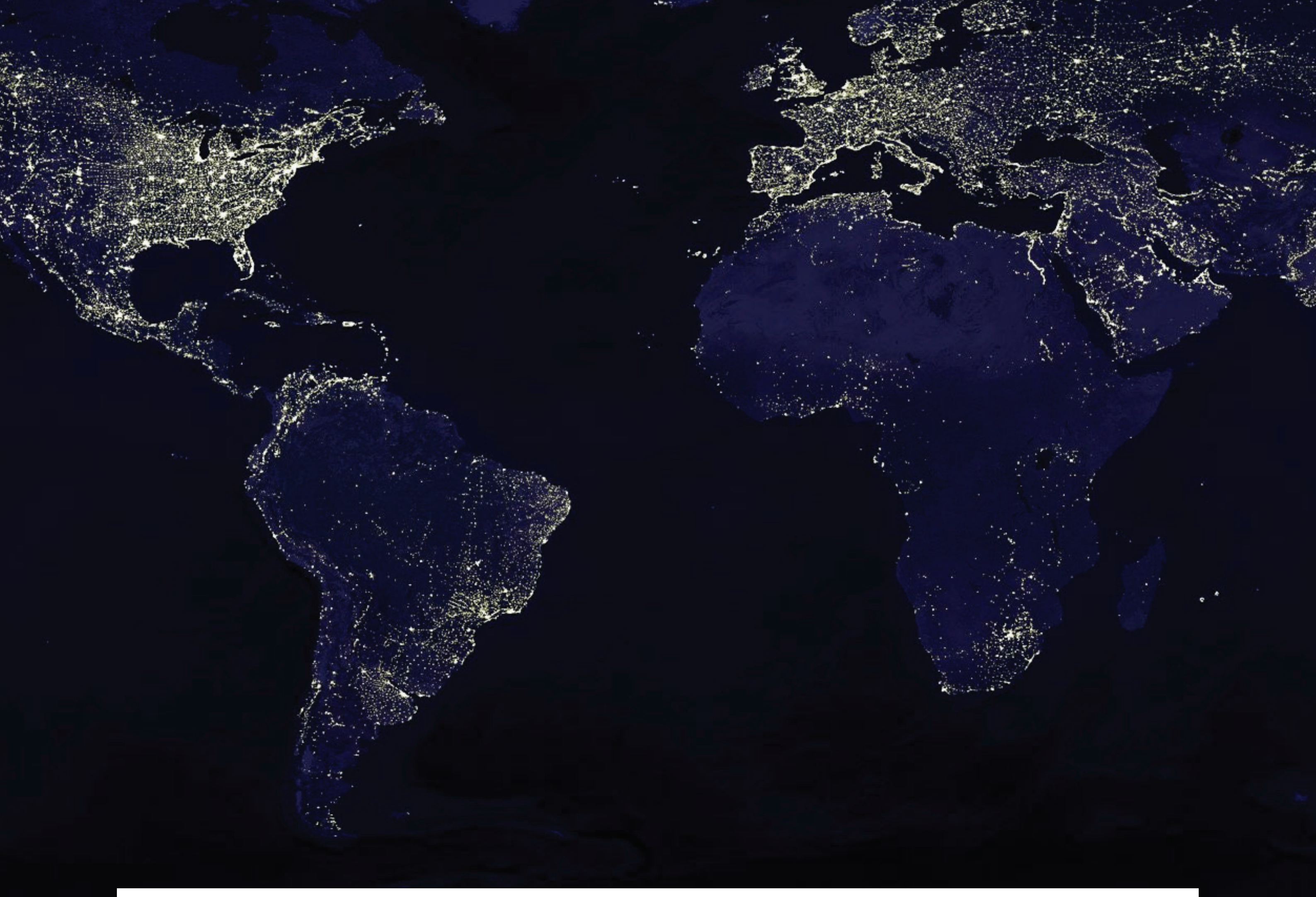
The Evolution of ESG: Pre, During and Post Coronavirus

By Mike Scott



EXCLUSIVE INSIGHTS FROM:

Ceres

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Thank you for downloading the latest whitepaper in the ESG content series from Reuters Events. It is our ambition to keep the ESG conversation flowing throughout this difficult Coronavirus period. Over the summer I will be creating a series of webinars, whitepapers, podcasts and more. We will then resume our physical conferences in New York this September (22nd-23rd) - see **here** for more details.

We value the thoughts and contribution of our ESG community highly and would welcome your feedback. Furthermore, there are plenty of opportunities to work collaboratively in the coming months and again for the conference in New York, if you would like to be involved please do email me direct: dominic.grocott@thomsonreuters.com

I hope you enjoy this article outlining how the ESG conversation has changed due to Covid-19, and impact this will have post-pandemic.

Very best,

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We are living through extraordinary times as the world fights to control the coronavirus pandemic. Economic orthodoxy has gone out of the window as governments throw everything they have at the issue.

This is happening just at the time that investors were starting to embrace environmental, social and governance (ESG) issues such as climate change, human rights in supply chains, diversity and executive pay. As a result, some argue that ESG issues, which are also known as non-financial risks, will inevitably have to take a back seat as we pick ourselves back up as the virus recedes.

But others say that the pandemic reinforces the need for investors to consider these issues. "Never has the need to build a more sustainable, inclusive economy been clearer or more urgent," says Mindy Lubber, CEO of sustainable investing non-profit Ceres. "This pandemic is a painful reminder of our universal interconnectedness, our vulnerability to the seismic risks and sudden shocks our current capital markets systems expose us to, and the need for mass mobilization to tackle a common crisis."

This is not just a cuddly message of solidarity at a time of national stress – it could be the difference between a business surviving the crisis or going under, information that is vitally important to investors such as pension funds and insurers who want to know where they should deploy the money of their policy holders and beneficiaries.

Jamie Smith, corporate governance specialist at EY's Americas Center for Board Matters Investor Outreach, says that investors are particularly interested "in how companies are addressing ESG matters to build resiliency amid continued disruption, accelerating climate risk and other trends shaping the global business landscape. They also want to better understand how boards are evolving their practices to strengthen board composition, enhance perspective and better navigate rapidly evolving risks."

The reason for this is that companies that are managing these issues well tend to perform better financially, be more resilient and have higher valuations.

Bloomberg **analysis** reveals that, to date, the average ESG fund has seen its price fall by half the decrease registered by the S&P 500 Index over the same period during the Covid-19 crisis.

"It's unusual to find investors now who have not tried to get smart about this very quickly"

Index provider MSCI **adds** that ESG indexes have outperformed their benchmarks since the start of the year and that companies with high ESG scores have a lower cost of capital, and above-market valuations and profitability. Ashish Lodh, vice-president of Equity Solutions Research at the firm, **says** that "companies with high ESG scores, on average, experienced lower costs of capital compared to companies with poor ESG scores during a four-year study period. Corporate management may wish to consider that strong management of financially relevant ESG risks has been aligned with investor interests."

Before the pandemic struck, investors were most concerned about talent management, environmental issues and climate change, according to EY. "Nearly two thirds of investors (64%) said that having an appropriately skilled, fully engaged and diverse workforce is critical. Some stressed that in this era of rapid technological disruption and cultural shifts, human capital is essential to helping companies adapt, problem-solve, innovate and increase productivity," the consultancy said in a February report, **What investors expect from the 2020 proxy season**.

More than half (56%) also cited effective management of environmental issues and climate change as critical to the strategic success of their portfolio companies over the next three to five years. "While some noted the upside opportunities of successfully navigating climate change (e.g., differentiation in the marketplace, getting ahead of regulation, reputational benefits with consumers and employees, new revenue streams), others asserted that a carbon constrained economy would create net negative impacts for most companies. With this paradox, investors are identifying corporate resilience and sustainability as the mark of strategic success in this area," the report noted.

The growing interest in ESG issues in recent years has come about because a range of events (such as BP's Deep Horizon disaster and VW's Dieselgate) and megatrends (including climate change, growing concerns around human rights in supply chains and the debate around diversity) have shown that such issues are becoming harder and harder to ignore.

Consideration of sustainability has moved from a niche market of religious and socially responsible investors that were values driven to a situation where all the big investment firms have some kind of ESG products in their portfolios.

Interest in ESG has grown tremendously in the investment community in recent years, says Katie Schmitz Eulitt, director of Investor Outreach at the Sustainability Accounting Standards Board (SASB). "It's unusual to find investors now who have not tried to get smart about this very quickly, and they are starting to understand the links between ESG issues and their business operations."

Lubber says that the reason for this new-found enthusiasm is that the ESG community has been able to make the case that this is not about values investing, important as that is for some investors, but about the financial implications of sustainability risks on portfolios.

One of the main reasons for this is that many of these issues, ranging from drought, flooding and wildfires to the impact of zero hours contracts, and executive pay, "have played out in real time to show how they can impact corporate value," Schmitz Eulitt adds. "Many long-term investors with very long-term liabilities are understanding they need to take a longer view of value creation. That has fed its way into the thinking of asset managers."

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Another reason is that there is a growing amount of data available – and technology such as big data analysis and artificial intelligence that can turn that data into useful information – that allows investors to see the impact of sustainability factors on their portfolios. "Every sector of the economy is affected by an issue such as climate change," Lubber points out. "Climate risk in the portfolio is not an environmental issue, it's a substantial material financial risk like any other. Not analysing it is jeopardising your investment."

As a result, the investment community is starting to step up on sustainability, both individually and as a group. One of the most notable signs that things were changing was when, in 2018, Larry Fink, CEO of the biggest asset manager of all, BlackRock, wrote to the companies that his firm invests in.

"Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society," he wrote. "Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate. Without a sense of purpose, no company, either public or private, can achieve its full potential."

Since then, a stream of announcements has come from investors embracing sustainability issues, including the recent news that the asset management arm of JP Morgan will incorporate ESG factors into all its investment analysis.

In the meantime, the investor group Climate Action 100+, representing more than 450 investors with in excess of $40 trillion of assets under management, has had considerable success targeting the world's biggest greenhouse gas emitters and pressuring them to act to cut their emissions.

Oil companies such as Shell and BP have committed to report on their climate impacts and how they plan to deal with them, while 11 companies have reviewed their membership of trade bodies that are not aligned with the Paris Agreement requirements on climate change.

ESG in the age of the pandemic

The COVID-19 crisis is not a financial crisis, but could potentially impact all industries, particularly those issuers that have lower credit quality, are more leveraged and have lower ESG characteristics due to simultaneous supply and demand shocks, MSCI says.

One reason the crisis created by the pandemic could push ESG up the agenda is that it is the ultimate non-financial risk and it highlights how issues that are not traditionally seen as central to business performance can have a huge impact on a company's fortunes. It has also demonstrated the importance of ESG issues such as the need for continuity planning, how prepared companies are for a disaster, how resilient they are to unforeseen events such as this.

"Resilience is about much more than withstanding a sudden shock to markets – it also means understanding and addressing long-term structural changes," Fink wrote in his most recent letter to shareholders. "The money we manage belongs to our clients, and we can only serve them if we address how global changes will impact their outcomes."

Lubber adds that "with the pandemic, we are seeing what systemic risks look like. It's not something we want to see happen again. We need to be prepared for the next crisis. I hope lessons will be learnt."

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Nigel Green, CEO of $12bn financial advisory group De Vere, says that "the coronavirus pandemic will trigger a 'skyward surge' in sustainable, responsible and impactful investing over the next 12 months for three key reasons. First, before the pandemic, research has revealed that investments that score well in terms of ESG credentials often outperform the market and have lower volatility over the long-run. Since the Covid-19 public health emergency up-ended the world, the latest broad analysis shows that ESG funds have typically continued to outperform others."

"Second, the coronavirus pandemic has underscored the vulnerability and fragility of societies and the planet. It has underscored that increasingly companies will only survive and thrive if they operate with a nod from the wider court of public approval.

Green adds that "demographic shifts will support the trend. Millennials cite ESG investing as their top priority when considering investment opportunities. This is crucial because the biggest-ever generational transfer of wealth – likely to be around $30trn - from baby boomers to millennials will take place in the next few years. ESG investing was already going to reshape the investment landscape in this new decade – but the coronavirus will quicken the pace of this reshaping."

This is as true in the US as it is in Europe, where investors were quicker to consider ESG issues, says Schmitz Eulitt. "Investors in the two markets are far more alike than they are different. There has been a perceived lag but US companies have been working really hard to report on their issues and they are catching up pretty rapidly."

Dr Alex Koberle of the Grantham Institute for climate change and the Environment points out that "this crisis has exposed many vulnerabilities that can be traced back to the unsustainable development that has ravaged the environment, and yet failed to eradicate poverty and hunger. Governments should take a moment to reflect, learn from past mistakes and redirect development towards a sustainable future. Medical professionals are putting their lives on the line to contain the virus; decision-makers owe it to them to rebuild the world in a way that makes it more resilient to similar situations in the future."

The bottom line is that ESG issues matter to the long term performance of a company when they are relevant and material adds Leon Kamhi, head of responsibility at the International business of asset manager Federated Hermes. "If companies ignore the environment and society, their customers and employees, then their success and the returns they deliver will simply not be sustainable. This applies to European and US companies alike and to investment strategies being run out of either region.

"The difference in the US relative to Europe is that there is a stronger focus on the fiduciary, and it would seem a greater proof required to demonstrate that an ESG issue is material. This is all the more so when there is uncertainty on whether an ESG issue will have a material impact. In Europe, there is less of a burden of proof required. That is why climate change – whose materiality is now generally unquestioned – was taken more seriously by more people in Europe than it may have done in the US at least until recently."

As we emerge from the crisis, the Financial Times says that "one of the consequences of the pandemic must be a redrawing of the relationship between business and society", which companies with a strong focus on ESG will be best placed to navigate.
"ESG is not a passing fad, a bull market luxury, it's a bear market necessity," Schmitz Eulitt points out.