INSIGHT
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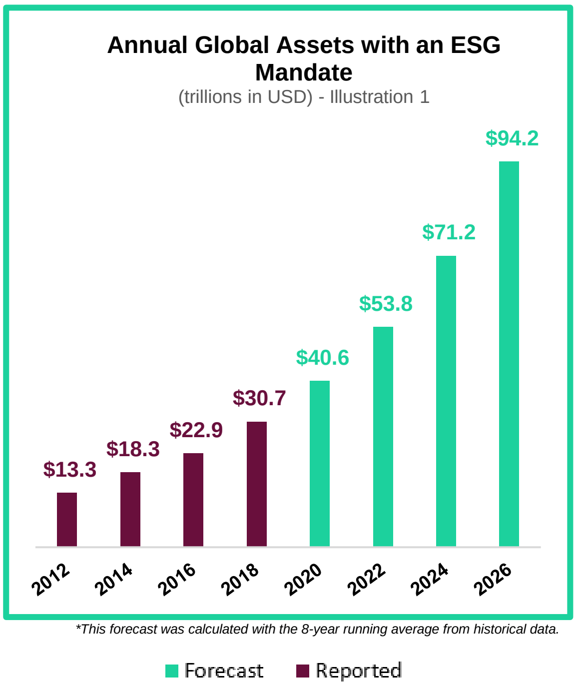
How does the Coronavirus Global Pandemic Impact the Sustainable Investment Revolution?

A deep dive into what this means for corporations, investors, and asset managers

Background

The Sustainable Investing [1] movement has gained tremendous international support over the past decade; however, the effects of the coronavirus pandemic on this momentum are still unclear. Sustainable Finance and ESG (Environmental, Social, Governance) methodology have been widely adopted due to an 'ethical squeeze' from rising demand from investors and regulators as well as supply factors such as corporate leaders driving the charge like Larry Fink, CEO of BlackRock. According to the Global Sustainable Investment Alliance, between 2016 and 2018, there was global growth of 34% of assets with an ESG mandate (Illustration 1)[2 3 4 5].



This forecast was calculated with the 8-year running average from historical data.

Global disasters have always posed a challenge to CEOs, their shareholders and asset managers; however, the Coronavirus pandemic represents the greatest impact of a disease on financial markets in the last 35 years.[6]

Although there has been a resurgence in the market since the drop in March, financial markets have not experienced this level of volatility since Black Monday in 1987 [7]. On March 23rd, the S&P500 bottomed out at 2,191 which was a drop of "35% from its February record"[8].

What is Sustainable Investing?

Sustainable Investing is an investment approach that considers environmental, social, and governance (ESG) factors in portfolio selection and management. The Global Sustainable Investing Alliance has classified the following 7 forms of Sustainable Investing:

1. **Negative / exclusionary screening**: exclusion of investments based on specific ESG criteria from a fund or portfolio
2. **Positive / best-in-class screening:** investments selected for positive ESG performance relative to industry peers
3. **Norms-based screening**: screening of investments against minimum standards based on international norms, (OECD, ILO, UN, UNICEF, etc.)
4. **ESG integration**: the systematic inclusion by investment managers of environmental, social, and governance factors in financial analysis
5. **Sustainability themed investing**: investment in themes or assets specifically related to sustainability (i.e., clean energy, green technology, or sustainable agriculture)
6. **Impact / community investing**: targeted investments aimed at solving social or environmental problems, and including community investing in underserved individuals and communities or businesses with a clear social or environmental goal
7. **Corporate engagement and shareholder action:** the use of shareholder power to influence corporate behavior (i.e., communicating with senior management and/or boards of companies, ESG proxy voting, etc.)

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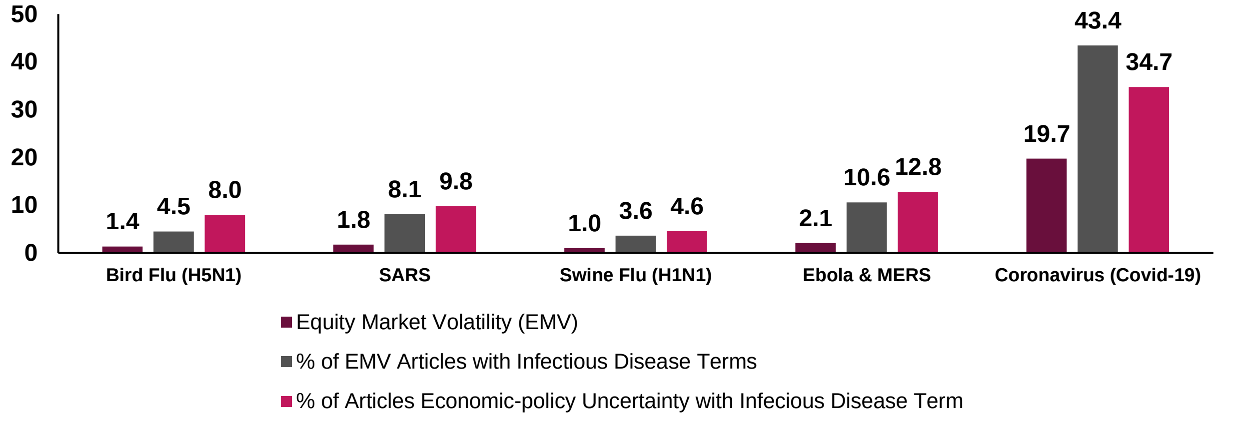
[1] http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf
[2] http://gsiareview2012.gsi-alliance.org/pubData/source/Global%20Sustainable%20Investement%20Alliance.pdf
[3] http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf
[4] http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf
[5] http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf
[6] https://insight.kellogg.northwestern.edu/article/what-explains-the-unprecedented-stock-market-reaction-to-covid-19
[7] https://insight.kellogg.northwestern.edu/article/what-explains-the-unprecedented-stock-market-reaction-to-covid-19
[8] https://www.cnbc.com/2020/04/16/larry-fink-coronavirus-low-last-month-may-have-been-the-market-bottom.html

Stock Market Volatility in Selected Infectious Disease Episodes
Illustration 2



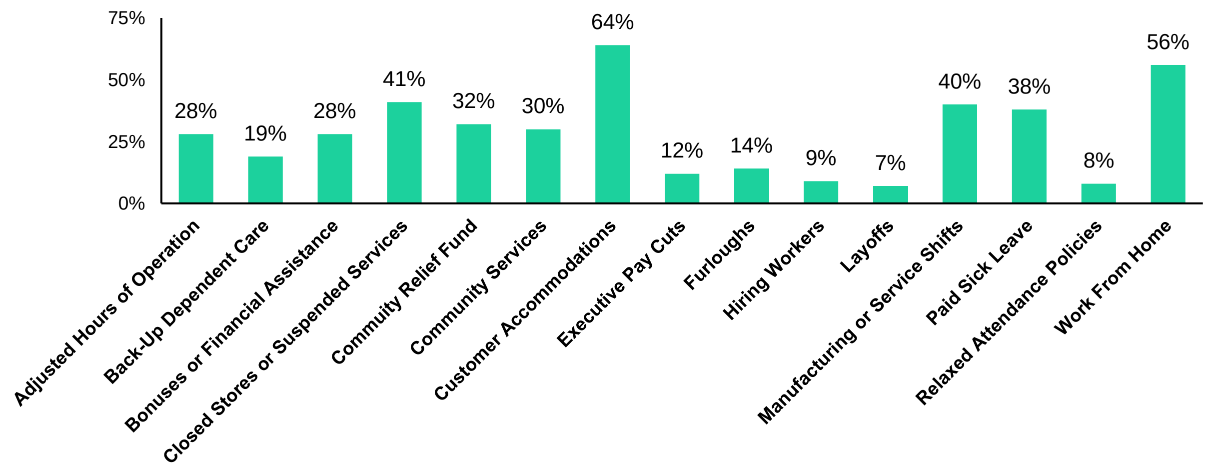
The Kellogg School of Management developed an Equity Market Volatility (EMV) level tracker based on the number of articles related to equity market volatility rescaled to match the mean value of the VIX (volatility index). The impact of each infectious disease on the equity market volatility was proxied by the percentage of EMV articles that contained infectious disease terms. As relayed in the chart above (Illustration 2) [9], in the last 35 years, no other infectious disease has had such an impact on equity market volatility.

The coronavirus global pandemic is one of the greatest natural experiments in modern history, challenging our beliefs, the way we work, and the way we invest. This article analyzes the effects of the coronavirus pandemic on sustainable investing methodology and ultimately, what this means for corporations, investors, and asset managers.

What is the Impact on Corporations?

With all eyes on how corporations maintain business continuity, it is imperative that the corporate policies implemented are set to a high standard that aligns with their investors, customer base and international NGOs. COVID-19 has challenged corporations by forcing them to adopt strategies such as work-from-home policies or paid leave for employees. Below is a snapshot of the rapidly changing landscape of pandemic responses by the 100 largest US public employers (Illustration 3)[10] .

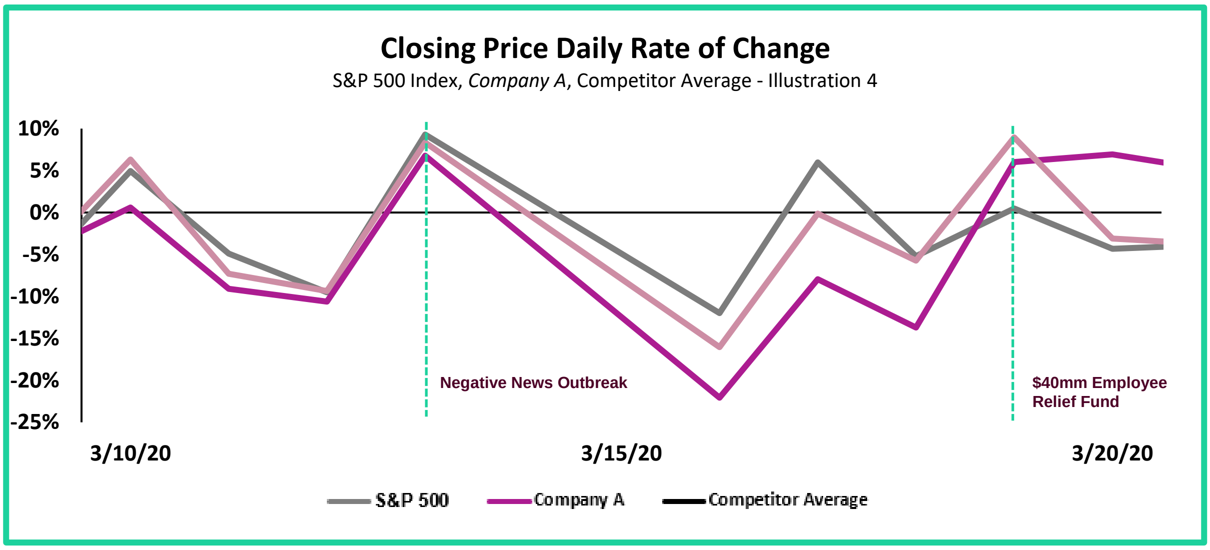
How America's Largest Employers Are Responding to the Coronavirus Crisis
As of March 30, 2020 - Illustration 3



[9] https://insight.kellogg.northwestern.edu/article/what-explains-the-unprecedented-stock-market-reaction-to-covid-19
[10] https://justcapital.com/reports/the-covid-19-corporate-response-tracker-how-americas-largest-employers-are-treating-stakeholders-amid-the-coronavirus-crisis/

While the future remains precarious, the public is quick to react emotionally, and people often find themselves at odds with large corporations. Compounding with the present-day sensitivities of society, the oversaturation of COVID-19-related news both on social media and through news outlets has led to a significant impact on the stock market based on emotional investment decisions.

This relation between company equity price and public relations is exemplified when a popular fast food restaurant chain faced backlash for their policies surrounding employee sick leave during the pandemic. The parent company of this fast food chain, *Company A*, was quickly put under public scrutiny on March 13th, 2020 when a news organization, *PressProgress*, shared that the company required their employees to provide a doctor's notes in order to take sick leave, whether paid or unpaid, even during the pandemic.[11] This was quickly picked up and shared among news outlets across Canada. Within the same day that the news was announced, a movement to boycott the company was trending on Twitter as users voiced their disdain at the company's disregard for its employees' and customers' wellbeing.[12]



The graph above (Illustration 4)[13] shows the stock performance of *Company A* over the time period of the backlash. At the end of the day on March 13th, 2020, the stock price was $45.63. Within five days of the negative news break, the stock price had dropped to a low of $28.25 by March 18th, 2020, resulting in a 38% decrease. This was the largest downward spike that their stock had taken during the COVID-19 outbreak and has since recovered largely due to their prompt response.[14] This 38% decrease is significantly greater than their competitors' price drops. Their competitors' stock prices dropped around 20%, on average, during this same time period, while the S&P 500 index saw a 12% decrease.[15]

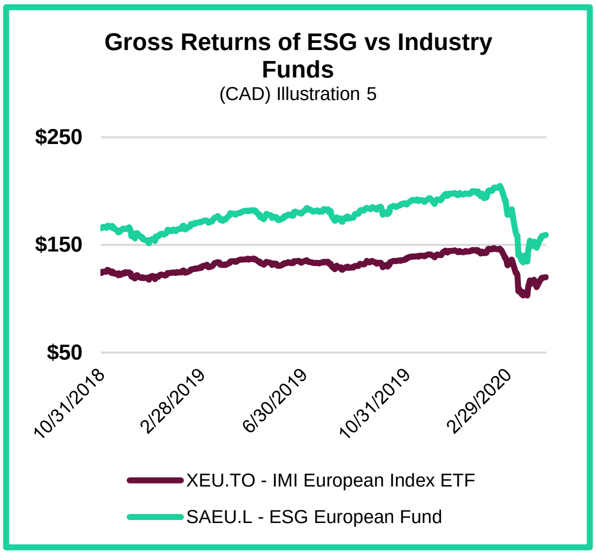
The food chain was quick to respond to the backlash the following day.[16] Three days later, on March 17th, they announced that they would be providing a $40 million CAD fund for staff affected by COVID-19.[17] Immediately following this announcement and their retraction of the original policy, their stock recovered, showing a positive percent change on March 19th.[18]

As more employees look to their management for guidance on how to maintain their operations, investors will be closely monitoring how companies execute governance plans. What is yet to be seen is the long-term financial consequences these companies will face and its impact on their ESG scores.

[11] Available upon request.
[12] Available upon request.
[13] Data from Morningstar.
[14] Data from Morningstar.
[15] Data from Morningstar.
[16] Available upon request.
[17] Available upon request.
[18] Data from Morningstar.

What is the Impact on Investors and Asset Managers?

Q1 has ended and some early results show that despite the volatility caused by panic-driven selloffs, ESG equity funds have yielded greater returns than their conventional counterparts[19]. According to the Financial Times, 62% ESG Large-Cap equity funds outperformed the global tracker as per data from Morningstar[20]. As per the chart below (Illustration 5)[21], ESG focused funds have stayed resilient and outperformed their conventional counterparts.



Environmental, social, and governance-focused funds yield more stable returns during the pandemic because they consist of companies that may:

1. Have invested in better social and governance policies, which allows them to be more adaptable in the face of crises (i.e. have better Business Continuity Plans in place, implement work-from-home strategies more efficiently, etc.);

2. Can signal better employee treatment standards and Corporate Social Responsibility during the pandemic, allowing them to benefit from better marketing communications and public relations with customer base;

3. Have better ESG metrics; these are typically large public corporations that have risk-averse balance sheets, lower controversy levels, and international customer bases buffering them from regional Coronavirus outbreaks.

Although, unrelated to the pandemic the resiliency of ESG funds also coincided with low oil prices as a result of the lack of supply control from OPEC in March[22]. As environmentally friendly funds tend to be less oil-dependent, they were likely protected from the oil price drop as well. It will be critical to closely examine the performance of ESG funds in the upcoming quarters since OPEC has agreed to cut back global oil supplies by 10%[23] [24].

Do ESG investments yield greater returns with lower volatility?

To preface, even before the pandemic, evidence had been mounting for decades that ESG investments yield greater and more stable returns. According to a research paper co-written by Deutsche Asset & Wealth Management and the University of Hamburg, out of 2,200 studies on ESG, 90% demonstrated that ESG has a “positive relationship to corporate financial performance (CFP) or at least no negative relationship”. Additionally, as per JUST Capital study, top quintile ESG companies demonstrated approximately 18% - 22% lower volatility in returns than the bottom quintile of ESG scores. This shows that corporations with greater ESG policies will better protect investors from downturn risks.

Some skeptics may argue that since there is a lack of industry standardization for ESG methodology, studies cannot accurately compare returns of different ESG funds. It is true that the ESG industry still faces many challenges, such as ‘green-washing’, but ESG reporting is becoming more standardized. Common industry standards have been developing over decades, such as the UN PRI Signatory guidance (United Nations Principles of Responsible Investing) and SASB reporting standards (Sustainability Accounting Standards Board). Additionally, international regulators like the European Parliament have set hard deadlines for standardization by 2022. In the United States, the “Disclosure Simplification Act” is awaiting Senate hearing, and if passed, will force all public companies to disclose their ESG data. As ESG gains new prominence, asset managers and investors must stay informed of the new standards that will be implemented.

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[19] https://www.ft.com/content/fe90fc64-c76b-4490-83ce-cc783246b1ba
[20] https://www.ft.com/content/46bb05a9-23b2-4958-888a-c3e614d75199
[21] Data from Morningstar.
[22] https://www.reuters.com/article/us-oil-opec-survey/opec-march-oil-output-rises-from-2009-low-after-supply-pact-collapse-idUSKBN21I2E6
[23] https://www.cnbc.com/2020/04/12/oil-prices-flat-after-opec-and-allies-agree-to-historic-production-cut.html
[24] https://www.cbc.ca/news/business/opec-oil-1.5530672

Not only are ESG funds outperforming in terms of returns and volatility, but it seems during the pandemic, they have been more resilient to mass sell-off[25]. The fund inflows for ESG equity and fixed income funds have performed above the market average during the pandemic[26]. In the month of March, where the markets were at their lowest, ESG funds reached a consistent growth of daily inflows[27]. Although ESG equity funds are still only a fraction of the global equity markets, this is evidence of their strength amidst downturns.

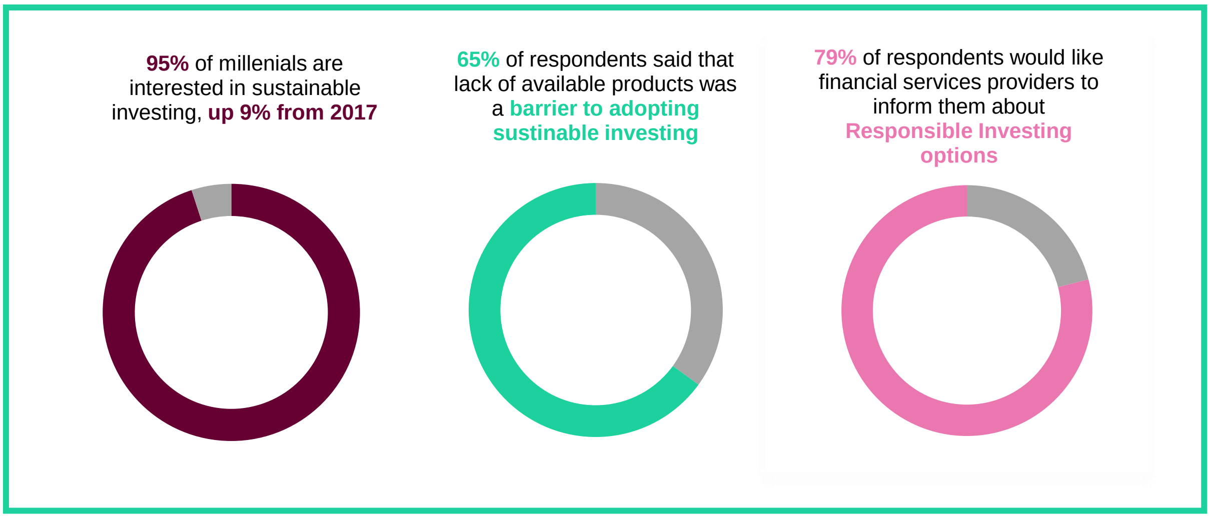
During the pandemic, the stable inflow into ESG funds may have been because of:

1. Investor speculation that ESG funds would outperform and have greater resiliency against economic downturns
2. Investor hyperawareness of Corporate Social Responsibility because of greater news coverage of corporate pandemic responses, encouraging greater investment into ESG funds

Sustainable Investing has been a steady trend previous to the pandemic, and there seems to be strong evidence that it will outlive the pandemic. As per the highlights of some studies below (Illustration 6) [28] [29] [30], money managers need to be able to explain the ESG risk considerations and provide more responsible investing options as there is only a growing appetite from investors and regulators.

Key Highlights – Investor ESG Preferences

Illustration – 6



[25] https://www.ft.com/content/dd47aae8-ce25-43ea-8352-814ca44174e3
[26] https://www.ft.com/content/dd47aae8-ce25-43ea-8352-814ca44174e3
[27] https://www.ft.com/content/46bb05a9-23b2-4958-888a-c3e614d75199
[28] https://www.riacanada.ca/research/2019-ria-investor-opinion-survey/
[29] https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf
[30] https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf

Looking Ahead

The COVID-19 pandemic upended businesses and prompted unprecedented changes to economies and countries internationally. While we have not yet seen the long-term effects of the pandemic, the data demonstrated the resiliency of ESG-focused funds during the crisis. The demand for ESG funds was already on the rise prior to the pandemic, but it seems that the pandemic will only accelerate the demand for more comprehensive ESG disclosures and Sustainable Investing options with pressures from both regulators and investors.

As investor sentiments change, asset managers will have to find ways to incorporate environment, social and governance factor policies into their funds to meet the expectations of their clients. Portfolios will have to be designed to account for non-financial risks such as climate change, human rights, diversity, supply chain controversies, carbon footprint, employee treatment and more. This will pose internal challenges and will require an in-depth evaluation of the core operating models of asset management firm.

As part of “Consulting for Good”, Sia Partners carries experience in policies and regulations surrounding ESG and corporate social responsibility. With expertise in risk management, operations, compliance, data analytics, and regulations, Sia Partners can help develop ESG policies for your company to acclimate in this new environment.

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