Covid-19: Does ESG matter?

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"I understand your passion for ESG, but we currently have other priorities". Whilst I respect this asset allocator's view, I think they are missing the point: ESG analysis is not a bull market optional but a tool designed to assess companies' resilience under stress. In fact, the Covid-19 pandemic is turning out to be an exceptional platform to discuss several hot ESG topics and to empirically verify its key assumptions.

Dealing with long term issues and qualitative data, ESG offers a set of useful instruments when examining exceptional events, especially ones with no similar occurrences in the recent past. This brief comment will not offer a general discussion, but an overview of single topics currently discussed among investors: ESG is not an abstract philosophy but a relevant real-life investment tool.

A quick quantitative note: during the steep declines experienced in the first quarter, ESG-based strategies were generally slightly more resilient and slightly less volatile than conventional, passive allocations. But I would not draw any bold conclusions: a single event, in isolation, doesn't offer a valid statistical argument. From a factor analysis perspective, the outperformance is not surprising given we know that ESG - as a factor - is positively correlated with quality and technology (which have outperformed) and negatively linked to the oil sector (which has underperformed, driven by a collapse in crude prices).

The collapse in fossil fuel prices was among the long-term scenarios discussed by ESG investors and one of the reasons behind the 'stranded assets' argument (investors abandoning oil companies due to concerns regarding their long-term longevity). The pandemic has acted as an external shock accelerating this trend. ESG-based asset allocations reduced losses during the market rout, as they pushed investors to allocate more to companies which were best prepared, more resilient and less exposed to this secular downtrend. From a purely environmental perspective, the lock-down has had a very good effect: pollution levels are collapsing, with flights grounded and car traffic greatly reduced. However, on a longer-term horizon, ultra-cheap oil prices are offering a perverse disincentive, delaying the switch to cleaner sources of energy.

With the virus somewhat easing environmental concerns, ESG investors are shifting their focus to 'G' and 'S' themes. A key social theme is the balance between employees' health and client service. On one side, companies are protecting their workers by reducing economic activity; on the other, they have a duty towards their clients. As clients, we rejoice for every parcel safely delivered in front of our doors, but we should not forget that each delivery is increasing risks for drivers, warehouse operators and other workers. Human capital management and health and safety have become a key differentiating factor, especially in countries where employees rely on insurance schemes funded by their employers. During a pandemic, a comprehensive health insurance is a great way of cementing employees' loyalty and reduce attrition, especially in low-skilled jobs where these benefits can be perceived as a key component of compensation.

The call for social responsibility has elicited strong responses in the banking sector: burned by the 2008 crisis, banks have a unique opportunity to switch from villain to hero, and they are collectively answering governments and regulators' call to arms. Brian Mohynian (Bank of America CEO), made clear to his shareholders that the focus must now be on employees, clients and communities. Banks will increase minimum salaries, freeze redundancies and stretch their balance sheets to accommodate further credit lines. For larger, stronger banks, it will be a great opportunity to strengthen their leadership position. On the other side, these bold choices will have some important governance implications such as a reduction in shareholders' remuneration, at least in the short term. Mohynian explained that "in the end, it will benefit you as a shareholder"; which is exactly what ESG is all about: managing risk and opportunities with a long-term approach.

The pressure on shareholder's remuneration has been felt even stronger in Europe, with banks in most jurisdictions being required to postpone their dividend payments and cancel share buyback plans.

On another note, managers' bonuses are another area of governance that will be of heated debate: CEOs will need to show they are in for the long run, sacrificing their short-term compensation in exchange of long-term incentives. A cap in executives' compensation is a legal requirement for any company receiving a loan from the US Treasury under the US support plan CAREs.

The pandemic has offered the opportunity to reposition a company's image, especially in controversial sectors: we have seen alcoholic beverage producers switch to producing hand sanitisers, whilst motor racing teams have experimented with the production of medical ventilators. Investors will need to carefully assess the difference between marketing stunts and a substantial redefinition of business models.

An interesting area under the governance category is business continuity and cybersecurity: notably the widespread implementation of work from home policies that have accelerated the trend in 'remotisation' of workforces, favoring companies and sectors with better IT infrastructure. While working from home keeps the workforce safe, it exposes companies and clients to a higher level of risk in their electronic communication. Some workers will access sensitive data from personal laptops, operated from their kitchens, potentially breaching their clients' privacy: a huge stress test on the integrity of IT network.

The events of 2020 will also have an impact on ESG country ratings. The level of funding devoted to national health services is clearly become a key variable defining resilience of an economy (and therefore its ESG credentials). Germany, for instance, has been managing the pandemic much more effectively than other European countries: which is not surprising given its per capita expenditure on healthcare is 45% higher than the European average.

Crisis management will probably redefine the role of the government and reshape the boundaries of its right to interfere with individual freedom: for example, the widespread use of tracking technologies generally attracts a negative effect on ESG ratings for a country. However in 2020, we discovered the social benefit of mobile phone tracking (mostly based on geolocation and Bluetooth technologies). In Asia, where governments are authorised to use more invasive surveillance technologies, tracking tools have massively helped controlling the pandemic and are contributing to a safer return to a normal life.

Life post-2020 will no longer be the same: when considering sustainable investments, we see these events accelerating the secular switch from traditional to ESG investing.

This article is written on behalf of the ESG Working Group.

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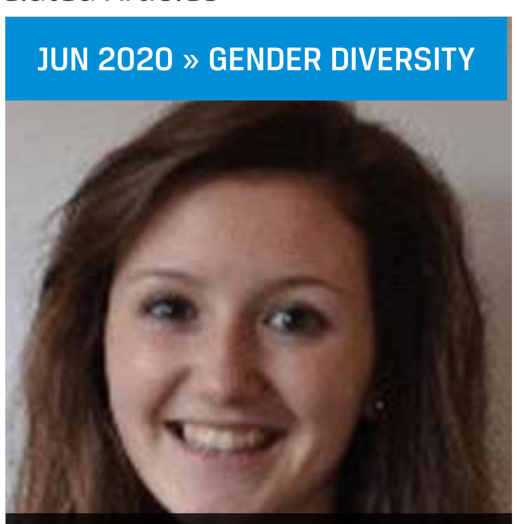

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