Millani MarketTrends

COVID-19 and its connection to ESG

By Milla Craig

Having spent many years in the capital markets, it's often said that the market anticipates economic issues before they actually hit main street. In this case, it seems that the financial markets are telling us that this COVID-19 pandemic will have deep and lasting impacts on our economy. As a leader in the ESG (Environmental, Social and Governance) space globally, over the past two weeks I've repeatedly been asked: "How will investors react? What will they be expecting of corporates?".

As we reach out to our clients, we can confirm that most of our corporate clients are in crisis management mode, simply trying to figure out how to manage the current reality. They're trying to figure out how to manage their relationships with their employees, their supply chain, governments, and generally their stakeholders. In addition, for many, they have the added stress of trying to figure out how they'll manage their upcoming annual reporting cycle, annual general meeting (AGM), together with all the communications and engagements that come with the probability of doing virtual AGMs this year. With all of this chaos, we're sure many are questioning "Why should we give any attention to ESG issues at this time?".

The thing is, the issues that we are experiencing are ESG issues and they have probably never been so important for your business. How you act and react, is and will be evaluated.

The "E" of ESG may not be what you think

The "E" in ESG is often thought to represent the environment. And for sure, for the past few years, capital markets have been shifting focus to environmental issues like climate change. During this short-term period of managing the COVID-19 crisis, we expect that this conversation may get displaced for a short while - but don't assume it's over.

In the short-term, the most relevant "E" in ESG will be in relation to your employees. How has the "employee experience" been? How your organization has been treating your employees has never been more important.

As public companies, you are being observed on how you are managing this crisis, not just by your employee stakeholders, but by your financial services stakeholders too. Are you taking their health, safety and wellness into account? One ESG issue where we've witnessed growth over the past 24 months in the articulation of a corporate's financially material ESG issues has been human capital. The ability of an organization to attract and retain talent is at a crossroads and this crisis will be a testament to your business's ability to do just that.

On March 27, the UN Principles for Responsible Investing (PRI) issued a notice to its signatories on "How responsible investors should respond to the COVID-19 coronavirus crisis".

In it, the PRI notes that the first action investor signatories should do is "engage with companies that are failing to protect workers' safety and/or their financial security, and those prioritising executives' pay and/or short-term returns to shareholders".[1]

The value of "S" in ESG

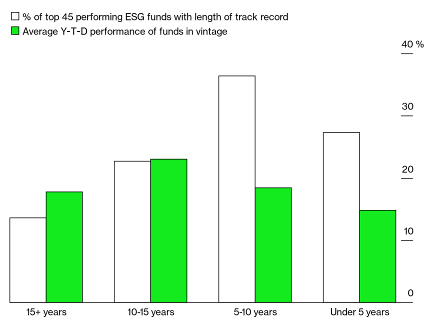
And the "S" in ESG. For so long we've heard that it's difficult to articulate the connection between social implications and economic value for a company. What we're seeing now with COVID-19 is the true interconnectedness of social issues and its impact on economic values.

It is difficult to articulate the value in measuring social issues, and what the impacts could be on the business and the wider economy if the issues are not well managed. As noted by Andrew Howard, Head of Sustainable Research at Schroders PLC, "We have long argued that companies don't operate in a vacuum. Their success reflects their ability to adapt to challenges and trends in the societies to which they belong. That is truer now than ever; social and environmental challenges, and investment drivers, are increasingly overlapping."[2]

1. "How responsible investors should respond to the COVID-19 coronavirus crisis", Principles for Responsible Investing, March 27, 2020. 2. "Coronavirus Pandemic Could Elevate ESG Factors", Wall Street Journal, March 25, 2020.

Of course, this crisis has led to significant declines in our capital markets and therefore, fund valuations. According to Bloomberg, of the 2,800 ESG-themed funds that they track globally, about 400 ESG funds remained in positive territory through this market correction.[3] They also note that "there were 45 funds that have managed to hold onto gains of more than 10% year-to-date and more than 70% of those funds opened before 2015".[4] *(See Figure 1)*

Figure 1: ESG Winners *(3)*



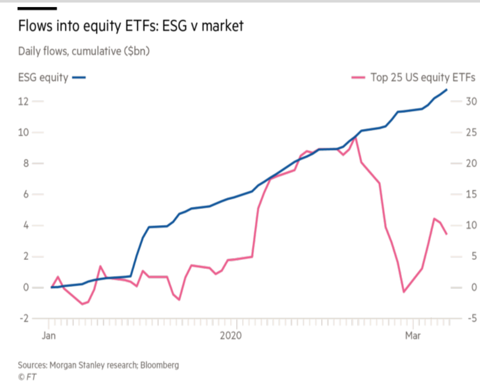
Older ESG Funds Outperform Their Newer Rivals in Market Tumult, Bloomberg, March 2020

As well, Bank of America (BofA) has noted that "From the S&P 500's peak to today, stocks in the top-quintile ESG ranks outperformed the market by over 5 percentage points (ppt). And this was not just due to less energy or small cap exposure; we saw nearly identical results on a sector- and size-adjusted basis. In Europe, ESG indices outperformed their benchmarks year-to-date (YTD) and the top 50 most over-weighted stocks by ESG funds have outperformed the most underweighted by more than 10 ppt YTD".[5]

This has also been noted by Jessica Alsford, an Equity Analyst with Morgan Stanley, who mentions "flows into ESG ETFs both on fixed-income and equities have held up better again versus the market … definitely the evidence so far is that it [ESG] has been more resilient".[6]

The BofA report also notes that investors have pulled less money from ESG funds than they have from other funds. "Recent flow trends indicate that ESG may be more of a bear market phenomenon. Of our BofA Securities clients, flows data indicated record ETF selling over the last few weeks but ESG funds have seen inflows for ten straight weeks. This explains that even after the market selloff, ESG ETF assets under management (AUM) are still up 5% YTD, while S&P 500 ETFs have seen AUM decline by over 30%".[7] *(See Figure 2)*

Figure 2: Flows into equity ETFs: ESG vs. market *(6)*



ESG Shines in the Crash, Financial Times, March 2020

So, what does that all mean? It means that the question of fiduciary duty for large asset owners might in fact be answered.

For the past decade there has been a perception that moving to ESG integration might reduce market performance and that it is the fiduciary duty of trustees to get the best returns. If these numbers stand true throughout this crisis, then this question should now be put to rest. With that, we should expect to see a lot of new assets flowing into ESG funds and that asset owners who haven't advanced on ESG, will need to do so.

In an increasingly competitive world for asset managers, you can rest assured that the ESG funds that have succeeded in having positive returns will be shouting from the rooftops the value of ESG and how they are best prepared to protect clients' assets. This will continue to drive competitiveness around ESG for asset managers and continue to put pressure on investee companies in portfolios.

Jeff Meli, Global Head of Research at Barclays PLC, has noted that "companies should expect more investors to ask questions about resilience and contingency planning, viewing the issues in light of the pandemic as relevant to a company's long-term performance… over the long term, I think if anything this would likely accelerate the focus on ESG from an investor standpoint."[8] Like many large investors and brokers, it was also noted that Barclays will begin providing ESG assessments for each of the companies that it covers.

3, 4. "Older ESG Funds Outperform Their Newer Rivals in Market Tumult", Bloomberg, March 13, 2020. 5. "Social enterprise stocks weather market storm better: BofA report", Business Standard, March 26, 2020. 6. "ESG shines in the crash", Financial Times, March 16, 2020. 7. "Social enterprise stocks weather market storm better: BofA report", March 26, 2020. 8. "Coronavirus Pandemic Could Elevate ESG Factors", Wall Street Journal, March 25, 2020.

"G" becomes about resilience and culture

Questions about resilience and long-term planning are Board issues. This is where the value of governance comes into play. How well has that Board reviewed the strategy? How well has the company's ERM system worked? These are questions that will be asked as we go through the recovery phase of this crisis and quite rightly, we'll see a lot of questions being asked about how the Board of Directors engaged in these areas.

Of course, the other success factor of these efforts will be the culture of the organization. We've spoken to a number of corporate clients over the past few weeks who tell us that their teams were up and running and putting their contingency plans into action quickly. That they were feeling very good about the plans that had been put into place and how quickly the teams were able to execute. That's culture. Culture is something that is created over many years and remains the responsibility of the Board of Directors.

It was a topic that we saw coming to the surface when we held events across Canada in the early part of 2020. We will be publishing more on this topic soon.

Ultimately the question corporates are now asking is, "Do I continue to spend money on the disclosure of ESG issues to the market? Will investors even care?" From our discussions, we believe that how a corporation acts now with your financial stakeholders, regarding your disclosure of these issues, will be as important as how you acted in the crisis.

Your investors, your bankers and your credit rating agencies will be watching how strategic these ESG issues are to your organizations; did you make major cuts, or is your communication around these ESG issues the last thing to go? As noted by BofA, "lower-ranked ESG companies in US, Europe and Asia have seen larger downward earnings revisions for 2020/ 2021". The market will anticipate these downgrades unless you proactively tell them your story and engage with them as well.

What's next? How sustainable finance fits into the recovery plan

In our view, the ability to engage with your financial stakeholders and your disclosure of your ESG issues has never been more important. With so much capital having been written off in the past month in the markets, if you believe your organization will need capital to restart the next chapter of your business's history, you should take notice of the fund flows into ESG and seriously consider the benefit of integrating your financially material ESG issues into your next corporate strategy.

In fact, over the past week we've seen a number of initiatives suggesting that recovery plans after this crisis should be "sustainable" in nature, including sustainable finance and ESG issues. As noted by Robert Walker, Chair of the Board of the International Corporate Governance Network (ICGN), "While still in crisis management mode, conversations behind the scenes provide mounting evidence that sustainable finance, investor stewardship and stakeholder capitalism will come out of this stronger than ever".[9] This is a sentiment that we are hearing very loudly as we look to an economic recovery.

We are confident that the future of business and capital markets will include ESG. It's well noted that we're all in this crisis together and now is not the time to waiver.

In fact, perhaps this crisis provides one of the best business and investment opportunities that we've all had in decades.

About Millani

Millani provides advisory services on ESG integration to both investors and companies. For the past 12 years, Millani has become the partner of choice for institutional investors, both asset owners and managers. By providing advisory services on integrating material ESG issues into their investment strategies and decision-making processes, we help our clients reduce risks, increase returns, and create value. Today, Millani is also leveraging this expertise and its experience in sustainability consulting to help reporting issuers improve their ESG disclosure to investors and optimize their market value.

For more information:

- Contact us at: info@millani.ca
- Visit our website: www.millani.ca

9. Interview with Robert Walker, Chair of the Board of ICGN, March 29, 2020