COVID-19 elevates the value of responsible investing

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Covid-19 elevates the value of responsible investing

“Unprecedented, disruptive, game-changing” — these are commonly heard words describing the COVID-19 pandemic and the shock it is creating for businesses, economies and governments, testing the fabric of our society and culture. Undoubtedly, this may mean significant changes for the world and the way we do business and interact with each other for the foreseeable future.

The silver lining is that the effects of this disruption should accelerate the analysis of potential future system shocks, differentiating companies that build resiliency across their entire value chain and those that do not. Responsible investing (RI) and environmental, social and governance (ESG) analysis has been evaluating and evolving systems approaches and studying resilience for some time. The value of ESG analysis is becoming increasingly clear.

We believe there is no better short-term evidence of this value than the performance of RI indices and investment strategies during this and the 2008 financial crisis. The sector-neutral MSCI ACWI ESG Leaders Index, for example, has outperformed the broad ACWI Index especially through the most recent market downturn in February and March of 2020 (Figure 1). We do note that style factors have a significant role to play in performance (in fact, the Momentum index outperformed the ACWI the most over Q1 2020, in addition to quality, growth, and minimum volatility indices). In the case of the MSCI ACWI ESG Index, the largest factor contribution was pure ESG followed by quality, volatility and momentum according to MSCI.

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1 Source: Datastream; MSCI ACWI style performances in USD for Q1 2020
2 MSCI, MSCI ESG Resilience presentation, April 7 2020
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Figure 1. Outperformance of MSCI ACWI ESG Leaders Index versus MSCI ACWI

Source: MSCI

Morningstar also found that for the first quarter of 2020, out of the 26 ESG index funds the firm tracks (US, global, emerging markets), 24 outperformed. Of 206 sustainable equity and ETF funds in the US, 44% ranked in the top quartile, 70% in the top two and only 11% in the lowest quartile based on year-to-date performance net of expenses.³

A similar pattern emerged during the 2008 financial crisis, with the MSCI ESG Leaders Index outperforming through the earliest phase, as shown in the light blue vertical bars in Figure 2, below. Given a large spike in volatility this past month similar to levels seen during the 2008 crisis (represented by the dark blue line below), it will be interesting to see if similar ESG performance patterns emerge. Highly rated ESG firms tend to be less cyclical and are more likely to be in the technology, healthcare and consumer nondurables sectors — all of which will likely do better in the current market environment and through the COVID-19 economic downturn.⁴ Among these patterns is the possible underperformance as markets rebound and cyclicals and energy potentially become more favorable.

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Figure 2. Cross-sectional volatility and relative performance of MSCI ESG Leaders versus MSCI World

Note: The light blue vertical bars represent the relative performance of the MSCI ESG Leaders Index compared to the MSCI World Index. The dark blue line represents the monthly cross-sectional volatility of the global stock market, and the light blue line is the smoothed rolling 12-month average cross-sectional volatility.

Sources: Refinitiv, Mercer.

Longer-term performance

There is much more to ESG performance, however, than just more robust performance through short-term market shocks. Since its inception in September 2007 to February 28, 2020, the MSCI ACWI ESG Leaders Index has returned 5.24% compared to 4.48% for the broad market and has outperformed in the one-, three-, five- and 10-year timeframes as well.3

A comprehensive examination of hundreds of published reports and academic studies over the past several decades also showed a positive relationship between ESG factors and company financial performance (CFP).6 More than 90% of these showed a neutral or positive connection between ESG and CFP. Recent Harvard research focusing on the materiality of ESG factors also supports the case.7 Long gone are the days when responsible investing was assumed to come at the cost of performance.

5 https://www.msci.com/documents/10199/9a760a3b-4dc0-4059-b33e-fe67eae92460
Future trends in RI from COVID-19

The COVID-19 pandemic and market correction and the extreme situation in which many companies now find themselves may highlight areas of additional study on ESG performance as well as evaluate its further added value.

Many responsible investors value companies with long-term resilience planning in their supply chains and labor forces, among many other “S” (Social) factors. Can ESG factors and RI identify companies that have invested in resilience, since they may be in a better position to weather the COVID-19 storm?

RI has been pushing companies to do more scenario planning for pressures and shocks related to climate, water stress and social issues, to name a few. Companies that have been doing this type of analysis should now be in a better position to manage the COVID-19 pandemic scenario as well. Will funds that value this approach also be able to manage market shocks?

The goal of sustainable investing is to deliver performance through a long-term stakeholder-centric approach that gives management a deeper understanding of the risks and opportunities of its business. Will this stakeholder approach now pay off?

Finally, will even more asset owners create mandates aligned with Sustainable Development Goals (SDGs) and a vision of a more sustainable world, creating a self-fulfilling feedback loop? Eventually, investing capital in companies that align with the SDGs and this vision may become increasingly favorable over short-term-oriented and exploitive business models. COVID-19 may well accelerate interest in creating mandates that make economies and society more sustainable, resilient and equitable. And perhaps that’s not such a bad thing.

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8 For one example among many others, PGGM has identified and created an investment mandate around four focus areas: climate, water, food security and healthcare. See https://www.pggm.nl/english/what-we-do/Pages/Focus-areas.aspx.
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