ESG investing: How Covid-19 accelerated the social awakening

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In 2014, to determine if environmental, social and governance (ESG) factors made a difference to shareholder returns, we analysed five years' worth of data. In doing so, we proved that ESG investing is more than just a feel-good phenomenon. Since then, we have continued to monitor how ESG factors impact shareholder returns – and every two years, we publish an intellectually honest assessment of the ESG investing environment. So far, our research has found that both social and governance factors are statistically significant, allowing us to further integrate sustainability into our investment portfolios. But since we published our last research paper in 2018, the world has changed dramatically.

A global wake-up call

The coronavirus and the imposition of lockdown restrictions across the globe have changed the way people live and work. Tales of shop shelves being emptied by panic buyers attracted criticism, but the pandemic has also brought out the best in people: many communities are working together to protect vulnerable members of society.

Companies, too, have been asked to consider the welfare of their employees and customers in ways unimaginable just a year ago. For example, banks are faced with widespread economic damage owing to the pandemic – and so, they are questioning how to balance the needs of shareholders with those of society. Against this backdrop, banks need to redefine their purpose from a social perspective.

These considerations, along with the climate crisis and the Black Lives Matter movement, have concentrated investors' minds and, as they have integrated them into their investment decision-making, more companies have been challenged for their substandard behaviour.

Our approach to ESG investing

At the international business of Federated Hermes, we believe there is no leading source of ESG data. We obtain research from 10 different data vendors, including Sustainalytics, Trucost, Bloomberg, MSCI, FactSet, ISS and CDP. This enables us to strengthen our conviction when assessing specific ESG practices. We also draw on insights from EOS at Federated Hermes (EOS), our stewardship team.

We assess a company's ESG profile relative to its geographic location and the industry in which it operates. We also use forward-looking metrics. This provides a view of both current and future ESG risks. By assessing a company's ESG profile in this way, it helps us identify whether it is undergoing a real improvement or deterioration in its ESG metrics. In addition, understanding the materiality of a company's ESG risks is an imperative. Together, these principles helped us to construct our proprietary ESG ranking, the QESG Score – a quantitative assessment of a company's ESG metrics compared to its peers and, crucially, how its ESG profile is changing.

Coronavirus puts social factors in the spotlight

Social factors have, on average, been effective in each of the last six calendar years – and in 2020, when the coronavirus pandemic proved its virulence, these factors have proved especially important. The ESG spotlight has turned to how companies treat their employees, customers and suppliers – and figure 1 demonstrates how social factors have correlated with outperformers in nine of the 11 GICS[1] sectors in the first six months of 2020. The strong relative performance of the Health Care sector dominates.

ESG investing: a long-term mindset matters

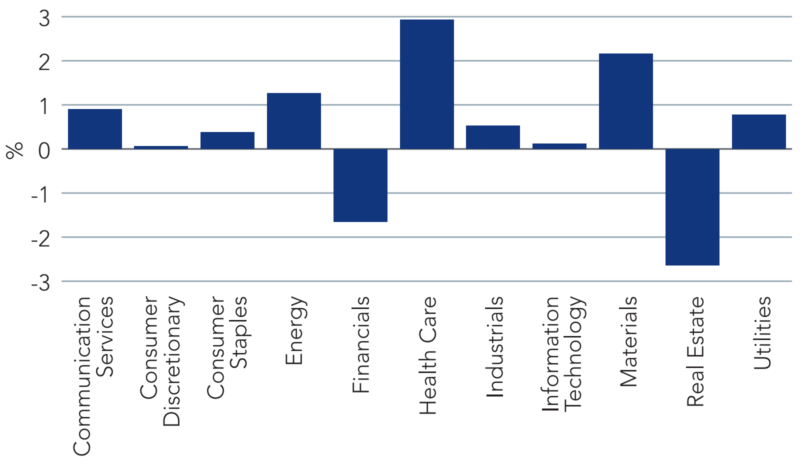
The rapid spread of the coronavirus pandemic and a crash in the price of oil rocked financial markets in late February and March 2020. As lockdown measures were announced around the world, economic upheaval challenged many businesses and threatened entire industries.

During this period, the qualities that mattered most to investors were strong balance sheets and operational efficiency. Other measures of quality or attractiveness were simply ignored by investors, and this included corporate governance. With the immediate future of companies at risk, it was understandable that investors focused on ensuring that the companies in which they were invested stayed afloat.

Indeed, the events of late February and early March remind us – and many other investors – that in extreme circumstances the key consideration is cash, while characteristics such as good governance were considered 'nice-to-have'. Our results show that companies with the highest rated governance scores have on average outperformed the lowest ranked companies in the first six months of 2020 with the exception of March.

Figure 1: Health Care dominates the sector analysis in 2020

Average monthly dispersion in total returns between companies in the top decile and lowest decile based on social scores by sectors from 1 January 2020 to 30 June 2020



Source: Federated Hermes, as at 30 June 2020.

Cash to survive, sustainability to thrive

This study, which analysed correlations between companies with high ESG scores and shareholder returns since 2009, reinforced our earlier findings of a robust link between underperforming firms and poor social and governance metrics.

Against the backdrop of the coronavirus, the world has had to deal with disruption of vast proportions – and amid heightened uncertainty about earnings prospects, investors have focused on the survival of the businesses in which they are invested. It is therefore unsurprising that the qualities that mattered during the pandemic-induced market crash were strong balance sheets and operational efficiency.

What's more, as the world continues its fight against Covid-19, many investors have sought high-growth, often speculative, companies. These high-growth names have historically often been run under dominant management with little regard to traditional standards of corporate governance – and this has not yet been to the company's detriment, as measured by shareholder returns. However, high-growth names in Europe and Asia have not been immune to the social awakening in recent years. Those companies with more social awareness than their peers have tended to outperform.

Today, the business case for protecting our environment continues to grow stronger. The transition to a more sustainable economy represents an exceptional market opportunity. Companies which play an active role in adapting to and mitigating some of the greatest challenges that we face today are likely to be rewarded through future policy and legislation, promoting greater sustainable development. The coronavirus crisis will perhaps hasten the speed of transition, and markets for obsolete, unsustainable products and services will decline. For this particular scenario, ESG investments are well positioned.

In these unprecedented times, we see growing awareness of sustainability across every sector. Embracing sustainability is not just about avoiding risks, it is about finding business opportunities. In this environment, it is that type of thinking which will enable businesses to thrive.

View the full findings of the report on our website www.hermes-investment.com

FOOTNOTE

1 The Global Industry Classification Standard (GICS) is a method for assigning every public company to the economic sector and industry group.

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