Environmental, Social, Governance Financing Goals in Post-COVID-19 World

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Abstract

The paper is based on the increased importance of environmental, social, and governance factors in the present-day investing, especially in the COVID-19 pandemic period. The increased trends are not only witnessed in developed economies but also evident in developing economics like India. The possible reasons are attributable to enhanced risk awareness and sensitivity of institutional investors towards ESG issues, thereby, leading to price discovery of ESG factors through increased integration in investment portfolios. The need for prioritizing social investments is clear, especially after the onset of the pandemic. However, the major barriers appear to be lack of relevant knowledge on ESG issues and apathy of investors in formulating an ESG investing framework. The paper provides certain insights on the present-day ESG frameworks and principles that can be adopted by financial managers and asset management companies to generate better risk adjusted returns.

Keywords: Sustainable Investing, ESG Investing, Risk-adjusted Returns, Institutional Investments, COVID

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Importance of ESG issues in finance and investing

While the importance of Environmental, Social, Governance (ESG) investing is already an established phenomenon with significant business benefits, the potential of imparting business benefits cannot be ignored in times of global uncertainties such as the COVID-19 pandemic. While the impact of COVID-19 on investments and management is not clearly established, its impact on market volatility, asset valuation, and portfolio allocation is inexorable. Moreover, the risk and return expectations of investors have also changed during and post the pandemic.

On the production side, there have been severe disruptions across the supply chain, especially in the oil and gas, banking and insurance sectors. These unprecedented disruptions have had severe operational and financial consequences with supply shortages. Needless to mention, these impacts have trickled down further to affect stock prices and institutional investments (PwC 2021; McKinsey 2021).

Contrary to traditional investing, sustainable investing (synonymously called Environmental, Social and Corporate Governance or ESG investing) provides an opportunity to investors to leverage upon the risks associated with traditional investments. These risks emanate from the various environment, social, and governance issues, which when integrated in portfolios can be accounted as ESG factors. These issues have catapulted in recent times. The increased prominence of these issues is not only due to a 'good to do' or philanthropic purpose but the increased recognition that ESG factors form around good business case. There has been a growing consensus of return-generating capability of ESG factors. Recognizing the value-generating potential of sustainable investments, firms are increasingly managing ESG risks by applying proper integration techniques and approaches. There is much evidence of increased recognition from sustainable investing and readjusting portfolios by institutional investors (Uzsoki 2020). Major asset managers such as Amundi and Blackrock have heavily increased their dependence on ESG-themed investments and have aligned their portfolios accordingly. Due to increased evidence of generating higher returns from sustainable investments, pension funds have started to consider ESG issues in processes to avoid breaching their fiduciary duties (Uzsoki 2020).

While ESG investing is already an established investment practice in developed markets, the developing markets are yet to integrate this approach in their practice. The reasons for underdeveloped ESG market developing economies can be attributed to reasons such as low level of awareness related to ESG risks, lack of well-grounded research to assess the impact of ESG factors on firm-level and portfolio performance, limited availability of ESG accounting and measuring frameworks, lack of sustainable investment products, and, most importantly, lack of reliable ESG data.

Given the fact that the pandemic has positioned itself as a systematic risk, ESG investing can act as a tool to leverage upon this risk and generate returns. Here after the outline of the paper is as follows.

Section 2 states the relevance and increased recognition of ESG issues during and post the COVID-19 pandemic period. The key trends in ESG investing during this period are elaborated in Section 3. Section 4 provides an outline of the sustainable financing framework and principles across the globe. The growth in ESG ratings and indices is presented in Section 5. Some of the time-tested ESG investing strategies adopted by institutional investors during the pandemic period is exhibited in Section 6. Section 7 presents the Conclusion.

Relevance of ESG issues in the pandemic period

The pandemic-crisis has reminded us to act and invest in ESG. This pandemic is a result of the environmental degradation that has led to destruction of natural resources, thus, making a way for pathogens to foster and find new hosts

(World Economic Forum 2020). In its report on COVID-19 Risks Outlook, WEF has further indicated that due to environmental degradation such disease outbreaks may occur frequently in the future that might lead to large-scale economic crisis, thereby increasing the risks and vulnerabilities to the society at large. This is an indication that both the public and the private sector need to alter their ways of functioning and prioritize aspects that were not considered important before, such as environmental degradation, climate change, social security policies and programmes, investments in the healthcare sector, corporate governance. As mentioned earlier, the impact of COVID-19 has largely been across the whole of supply chain, starting from production to consumption patterns. Subsequently it has also induced changes in the corporate decision-making processes, government policies, society, and the environment.

COVID-19 is a form of risk and vulnerability that every business can encounter, therefore preparedness is imperative, which is one of the core components of ESG investing. The risks emanating from unprecedented situations are not a new concept. In fact in the aftermath of H1N1 influenza and SARS, pandemics were considered as the second most prominent risk factor to the global economy. With the passage of time and increase in the occurrence of such events, public health catastrophes are known to have imposed severe threats to businesses and companies. Hence, one way of managing the impacts is to account for these risks. Responsible investment practices such as ESG investing is an investment strategy that integrates risks emanating from ESG issues and finds ways to reduce the vulnerabilities and risks associated with the pandemic situations. Financial performance, especially of infrastructure projects, is directly linked to ESG factors. ESG integration is a risk management tool that can lead to higher risk-adjusted returns over both the short and the long term. Several ESG research agencies such as MSCI have inferred that the companies which invest in ESG issues (and subsequently have high ESG scores) experience lower cost of capital and their potential to outperform rises as the cost of capital declines and the rate of returns improves (MSCI 2020).

The COVID-19 pandemic has triggered investments across all the three aspects of ESG, especially, the social aspect under which a company's policies and practices towards employees, suppliers, customers, and communities such as employment, pay equality, health, quality standards, and even labour conditions are considered important. Because of the pandemic, it has been estimated that in March 2020 when the lockdown was announced in India, the unemployment rate was 8.8% which shot up to 21.7% in May 2020 (CMIE 2021). This sudden surge in unemployment was due to the imposed lockdown exacerbated by the poor social security structures, significant prevalence of unorganized sector, and disguised unemployment. A large number of people employed in the unorganized sector in the urban areas were forced to migrate to rural areas during this period in search of alternate employment opportunities, thereby intensifying the social issue of disguised unemployment in India.

For an investor, the social aspect is important, managing the risks associated with ESG as well and the assessment of the extent of the risks involved. Since the outbreak of COVID-19, healthcare has become a pivotal part of ESG investing and now it plays an important role in deciding the avenues for institutional investments in the forthcoming years. The fallout of the global economy post the COVID-19 pandemic has also exposed the loopholes in the system. Lack of information and consolidated data on healthcare has further stressed the situation, persuading investors to diversify their investment portfolios by considering the social and, especially, the healthcare aspects. It has been witnessed that the companies that had prioritized health-related aspects during the past events of financial crisis have witnessed favourable impacts on employees, resulting in good health, higher productivity, and better job satisfaction during the present pandemic. Presently, opportunities for investing in healthcare sector are wider for investors as earlier lack of reliable data acted as a potential barrier.

The breakout of the pandemic has not only increased the importance of environmental and social aspects in investing but on governance as well. Corporate governance includes policies and procedures a company follows to achieve compliance and the other aspect is business ethics that demonstrates the way a firm chooses to deal with issues including corruption and bribery, independent directors on board, representation of women on board, gender-equity ratio and the like. The pandemic made governance also a major factor to deal with, as at every stage the companies had to make important decisions regarding the multitude of issues faced by the employees. Many important policies and procedures had to be revisited and reconstructed according to the pandemic, thus altering the governance structure.

The COVID-19 pandemic has proved that preparedness is one of the key factors to generate long-term returns. It has also made it clear that deliberation on labour policies and practices that can provide social security benefits or at least reduce the vulnerabilities associated with unprecedented situations is important. Already the impact of COVID-19 can be witnessed on ESG investing patterns and behaviour of the investors. During this pandemic, the focus on stakeholder capitalism model has increased, as it focuses on creating sustainable long-term value that serves all stakeholders and creates positive societal impacts (Hale 2021). The awareness has also grown for sustainability and the role of employees, customers, and the communities together are being considered important now.

ESG investing trends—quick facts

Investing in ESG has already been on the rise in the past decade and a surge can be seen in the number of funds constituting socially responsible investing (SRI), impact investing, and sustainable investing. Overall, the ESG assets have also grown at about 22% per annum since the inception of ESG in 2006 and as of March 2020, 521 signatories of the PRI group have managed more than USD 103 trillion in line with the ESG principles (UNPRI 2020)[1]. The demand for ESG funds has also increased and exceeded USD 1 trillion in assets under management (Boffo and Patalano 2020). The drivers identified for this rise primarily cater to the need to reduce risks, improve on-risk adjusted returns, and risk management that can help attain long-term returns. The increasing awareness about environmental and social issues has further pushed ESG investing.

There has been a rise in ESG investing trends during the pandemic period. Evidence suggests that the pandemic has accelerated the focus of the investors on ESG-themed funds. According to Emerging Portfolio Fund Research (EPFR), a wealth management advisory firm, equity funds with a focus on ESG mandates witnessed a record inflow of USD 168.74 billion in 2020 compared to USD 63.34 billion in 2019 (Jethmalani 2021). Global inflows in sustainable funds have increased by 88% and Europe accounted almost 80% of these inflows followed by the US where these inflows were marginally up at 13% from 12% in the last year. This trend was followed by the USA, Asia (ex-Japan), Australia/New Zealand, Japan and Canada. Supported by strong inflows in Europe, sustainable global assets have also neared the USD 2 trillion mark in the first quarter of 2021, which is an increase of 17% from the previous quarter. Europe accounts for the lion's share for 83% of the global assets followed by the USA (12%). Evidence suggests that there are currently 4523 sustainable funds available globally, which is ESG tilted and are, hence, able to manage risks in a better manner to improve the risk-adjusted returns. Figures 1 and 2 illustrate the state of global sustainable inflows and global sustainable assets.

[1] https://www.unpri.org/pri/about-the-pri

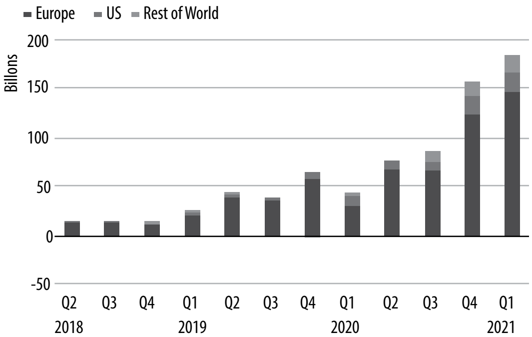

Figure 1 Global sustainable inflows

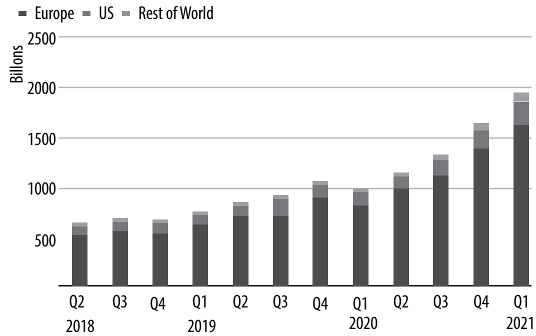

Figure 2 Global sustainable assets

Source: Morningstar Direct, Research Manager 2021

A survey by BlackRock[2] indicates that investors representing USD25 trillion in assets plan to double their ESG assets in the next five years. According to BlackRock survey, last year's sustainability portfolio concerns were topped by climate-related risks and around 88% of the respondents were in agreement to this.

The ESG exchange-traded funds and mutual funds analysed by S&P Global Market Intelligence with more than USD 250 million in assets under management also concluded that from 2020 to 2021, 19 of the 26 such funds performed better than the S&P 500. The S&P 500 increased by 27.1%, however the ESG ETFs increased between 27.3% and 55% during the same period. According to Morningstar Inc., investments in ESG funds by the USA in 2020 reached USD 51.1 billion, which is more than double the 2019 levels and nearly a ten-fold increase from 2018 levels.

Overall, the ESG fund flows have increased considerably since 2010, out of which bonds have had a majority share among all the asset types. Though their flow since 2019 has increased drastically compared to the previous years, but their flow in the first quarter of 2020 was much higher. There has also been a shift in the majority asset type from bonds to equities in the past few years and they have been on a rise, especially during the pandemic period. From a regional perspective, ESG funds witnessed a decline in the first quarter of 2020 compared to the fourth quarter of 2019 (be it EMIEA EX UK funds, or the UK and US funds that have always dominated). The UK funds declined from USD 4.3 billion in the fourth quarter of 2019 to USD 2.3 billion in the first quarter of 2020. Similarly, the US funds declined from USD 6.7 billion in the first quarter of 2019 to USD 2.4 billion in the last quarter of 2020[3]. However, now ESG considerations are being made in Asia Pacific as well in response to COVID-19 specifically. Investments in ESG funds have been slightly higher in Asia Pacific region compared to global investors. Similarly, it has been asserted that ESG funds were less volatile during the COVID-19 period. An analysis of the average volatility (defined by the historical standard deviation of returns) between funds with high and above average Morningstar Sustainability ratings and funds with lower ratings show that well-rated ESG funds had lower volatilities during the COVID-19 period (Sia Partners 2020). Thus, lower ESG-rated funds were more impacted by the pandemic-led crisis and suffered from a stronger increase in volatility.

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[2] Details available at https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-survey-shows-acceleration-of-sustainable-investing

[3] Details available at https://www.refinitiv.com/en

The impact of investing securities, measured by the S&P 500 ESG Index, also provides evidence that ESG funds have been less volatile during the pandemic and outperformed the broader market with a total return of 20.4% over the past 12 months as compared to the S&P 500's total return of 19.7%, as of February 9, 2021.

In India, ESG investing is gradually gaining traction since the past few years; however, it is still at a nascent stage. It has been estimated that in India, investments in ESG schemes rose from INR 2100 crore in the last fiscal to INR 3800 crore as of end of January 2021. Inflows in ESG mutual fund schemes has also increased by 76% in the financial year ending 2021, increasing to Rs 3686 crore from Rs 2094 crore (Iyenger 2021). In addition to this in 2020, India's large asset management companies such as Aditya Birla Sun Life, Axis Mutual Fund, and ICICI Prudential launched such schemes too that have a clear focus on ESG aspects.

Financing frameworks and principles of ESG investing

While the increased prominence of ESG investing in recent times, the key trends during the pandemic are clearly visible - ESG funds have performed better than its conventional peers. However, with increased importance of ESG investing it is also necessary for investors to align their activities according to a specific set of internationally accepted guidelines. The following sections present an overview of the important framework and principles in ESG investing.

Sustainability Accounting Standards Board – The SASB Framework provides guidance to investors to disclose comparable, consistent, and reliable ESG-related information. SASB's ESG approach emphasizes on financial materiality, the relative influence of each factor and sub-factor on an industry's financial performance, and constructs a materiality matrix for accounting ESG information. The information can be used by data providers, analytics platforms, and end-users such as civil society, academicians, researchers, and regulators. This materiality approach has been influential in shaping the choice of key metrics and weighing of the metrics to determine ESG ratings for different industries. The broad impact categories and indicators are illustrated in Figure 3.

Using these categories and indicators, the key industry-specific ESG issues are mapped accordingly. Table 1 provides some of the key industry-specific ESG materiality issues.

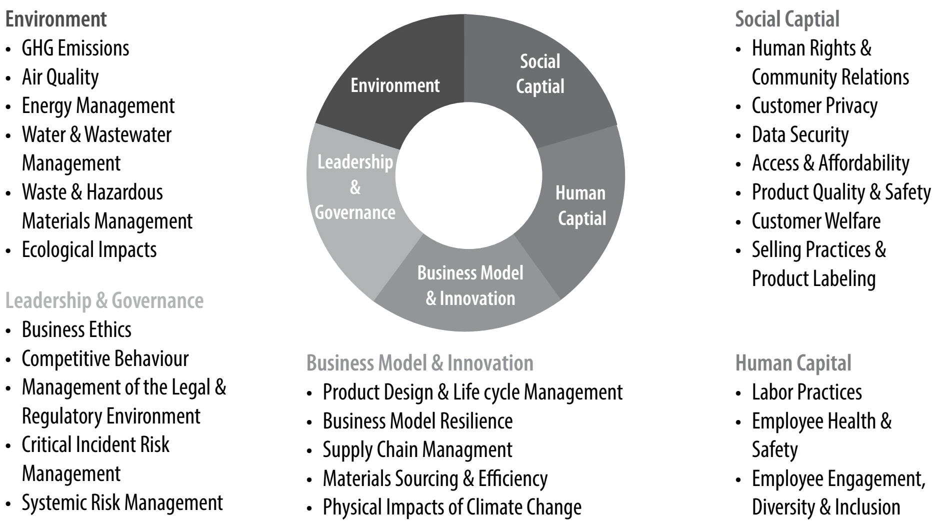

Figure 3 ESG impact categories and indicators, SASB

Source: Sustainability Accounting Standards Board (SASB)

Table 1 Industry-specific ESG material issues, SASB

Sector	Material ESG issues
Consumer Goods	Energy Management, Water and Wastewater Management
Financials	GHG Emissions, Air Quality, Energy Management, Water and Wastewater Management, Waste and Hazardous Materials Management, Ecological Impacts
Healthcare Infrastructure	Access and Affordability, Product Quality and Safety, Customer Welfare, Selling Practices and Product Labelling

Source: SASB

UN Principles for Responsible Investment (UNPRI) – The six principles of the UNPRI provide guidance to investors and investment managers to integrate ESG factors into portfolios by undertaking possible investment action. By adopting the principles, investors comply to incorporate ESG issues into investment analysis and decision-making, be active owners and incorporate ESG issues into ownership and practices, seek appropriate disclosure on ESG issues, help in promoting acceptance across industry counterparts, and report activities and progress towards implementing the principles. As of 2018, the number of signatories of the UN Principles of Responsible Investment (UN PRI) that commit to pursue ESG integration has grown to over 2300 signatories among institutional investors. The main motivators for this have been maximization of financial returns and enhanced risk management across asset classes.

UN Global Compact – The 10 principles of the UNGC are related to ethical standards related to human rights, labour, anti-corruption, and the environment. By adopting the UNGC principles, companies agree to adhere to business practices that are not complicit in human rights and abuses among other issues.

OECD ESG Guidelines – Similarly, OECD's due diligence guidelines for responsible business conduct helps businesses contribute to economic, environmental and social progress, especially by minimizing the adverse impacts of their operations, supply chains, and other business relationships. It includes human rights, employee and industrial relations, environment, combatting bribery, and consumer interests. Moreover, investors that seek to align investment strategies with ethical global development objectives, such as the Sustainability Development Goals, are seeking investment products that can help to improve alignment. Metrics related to ethical standards, including these UN and OECD guidelines, are incorporated in some frameworks for ESG assessment so that investors are able to assess and compare behaviour of issuers when making investment decisions.

MSCI principles – Considering the fact that companies have various exposures to ESG risks, an assessment of these risks is required to assess the long-term resilience of such companies. The MSCI principles emphasize on industry specificity, self-disclosure of ESG information by companies, independent and third-party verification for assessment methodology, incorporate a feedback mechanism for companies to raise issues or share additional publicly available information, and a robust editorial governance framework that underpins the third-party provider's ESG research and ratings process to ensure integrity and independence, including avoiding conflicts of interest.

ESG ratings and indices

ESG rating is a tool used by investors to understand the position of a company with respect to its peers on ESG performance. Ratings are developed by independent agencies such as Oekom, OECD, MSCI, etc. using ESG information available for companies through public disclosures. As a matter of fact, there is no uniformly accepted methodology to develop the ratings. However, the most common ESG indicators pertain to various aspects of E, S, and G components. These ratings are usually commercially available and it can be used by the financial industry for ESG assessments.

Some of these ratings form the basis of ESG indices. Evidence suggests that there has been a significant growth in ESG indices in recent years. This is mostly because investors are taking unprecedented enthusiasm in ESG-related funds and assets. According to the Index Industry Association, the number of ESG indices across the globe grew by 40% in 2020–21. Most of these developments have taken place in Europe, followed by the USA and Asia. Indices in fixed income have also grown significantly in the past two years, especially with a 7% growth in bond market indices globally. In India, the NIFTY 100 index is the only index that assesses companies based on their ESG scores. This index can be used for a variety of purposes such as benchmarking, creation of index funds, ETFs, and structured products. Figure 4 clearly illustrates increased index performance during the pandemic period vis-à-vis the earlier years.

ESG impactful strategies for investors

Some of the notable strategies adhered to by investors include exclusionary screening, positive screening, ESG integration, impact investing, and active ownership. While these are some of the common strategies used by investors, the extent of practice varies across different asset management companies and investing firms. Needless to mention, the objectives, investment, and impact considerations of the strategies can vary to a significant extent. Some examples of these strategies are provided in Table 2.

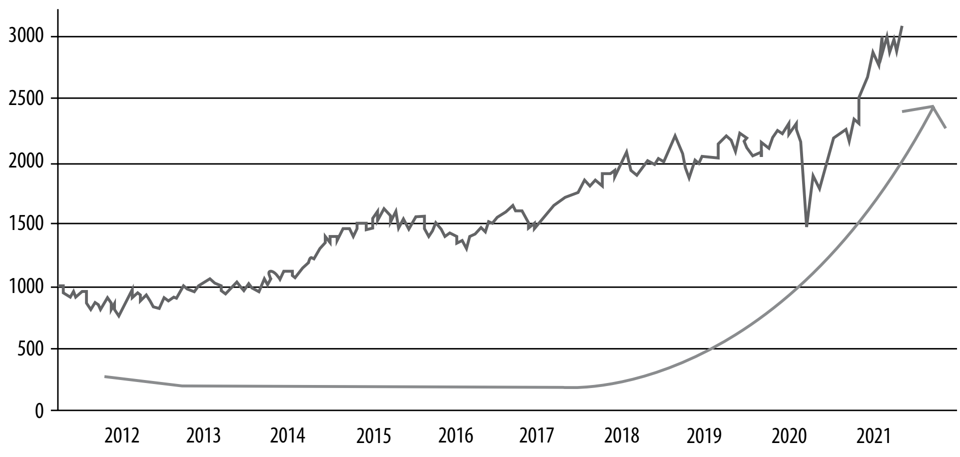

Figure 4 Performance of NIFTY ESG 100 Index

Source: NIFTY ESG 100 Factsheet, 2021

Table 2 ESG investing strategies

Strategy	Example
Negative Screening	Equity funds which invest in tobacco companies
Positive Screening	Equity funds which invest in oil and gas companies
ESG Integration	Actively managed fixed income funds which selects securities based on ESG issues
Impactl	Community investment fund that provides micro financing to low-income or disadvantaged communities
Active Ownership	Can apply to any fund where the asset manager or asset owner is committed to active ownership

Source: State Street Global Advisors

Concluding remarks

The paper has provided certain insights on the linkages between ESG investing trends and the COVID-19 pandemic and is reflective of increased prominence of sustainable investment during these unprecedented times. In fact, the pandemic has served as real time proof of increased resilience of ESG investing highlighting the future-proof nature of ESG investments managed through risk-adjusted returns. The paper also presents an overview of ESG frameworks, principles, indices, which act as pertinent sustainable investing tools for investors to deep-dive into material ESG factors. Some of the most impactful strategies that can be adopted by financial managers are also emphasized. Some of these strategies have been time tested and, hence, have proved to be very efficient to increase the long-term resilience of investment portfolios. It is worth mentioning that these trends are likely to continue. The message is clear: those companies that start early on ESG investing will get a larger pie of the growing sustainability linked finance pie!

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