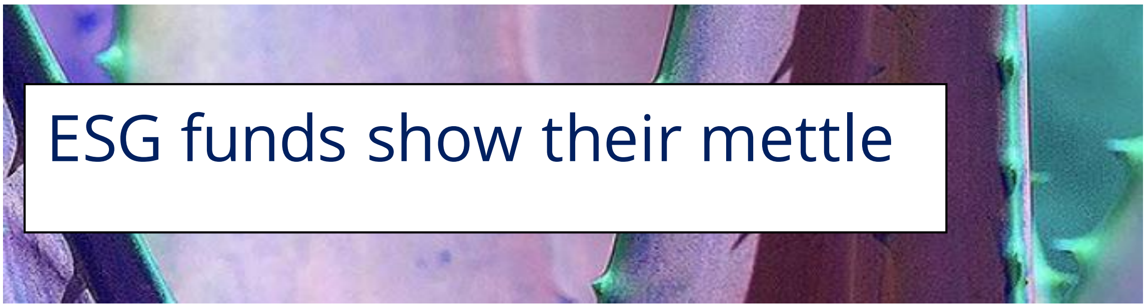

ESG funds show their mettle

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In the first quarter of this year, the Covid-19 pandemic prompted the most severe stock-market crash since the global financial crisis. But for investors who focus on environmental, social and governance (ESG) issues, there was some comfort to be found in the relative resilience of ESG funds.

In this turbulent period, we've been monitoring some trends; companies with better ESG ratings have generally outperformed the broader market. Indeed, this outperformance looks to be part of a longer overall trend. Funds that adopt some form of ESG strategy have by and large outperformed traditional funds over the past five years*. And stocks that are in the top quintile of Sustainalytics' ESG ratings have outperformed the S&P 500 since the fourth quarter of 2018 and have performed especially well, in relative terms, during the sell-off caused by Covid-19.

This is significant because the Covid-19 pandemic is by far the biggest market crisis that many ESG funds have faced. Most dedicated ESG strategies were launched after the 2008 financial crisis and so have been beneficiaries of the long bull market that persisted for more than a decade thereafter. There were shocks along the way, of course, but they were lesser in kind and duration than that of 2007–8. Now, however, that bull market has come to a dramatic end. And ESG funds appear to have come through the crash in good shape.

We should be cautious, though, in making any claims about this short-term performance – or in attaching any particular importance to it. After all, the essential attraction of funds that incorporate ESG factors is their focus on the *long term*, through good governance and societal and environmental sustainability.

It may also be true that the short-term outperformance of ESG funds owes more to their sector positioning than the ESG credentials of their component stocks. For example, many ESG funds tend to have high weightings to the healthcare sector and lower weightings to the energy and industrials sectors than mainstream funds. This means that the rotation out of stocks most exposed to the sudden slump in economic activity has helped the relative performance of ESG funds. So too has the plunge in the oil price, which has been caused both by the pandemic and by the ongoing dispute between Saudi Arabia and Russia. At the same time, the healthcare sector has been boosted by the strong performance of shares in healthcare companies that could potentially deliver treatments or vaccines for Covid-19.

Although these factors have been beneficial to ESG funds, the positioning of these funds is designed to achieve a long-term positive impact, not to provide short-term defensive qualities. Nevertheless, ESG and sustainability-tilted funds have consistently shown less vulnerability to downturns than traditional funds. This effect is particularly pronounced when markets have been especially turbulent – as in 2008, 2009, 2015 and 2018.

So we should not discount the inherent defensiveness of ESG strategies. We should, however, remember that volatile markets tend to be highly rotational. The stocks that have held up best during the sell-off may not be prime beneficiaries of a rebound in investor sentiment. It is possible, for example, that heavily polluting companies and sectors will bounce back strongly as the recovery from the crisis gets underway – which would be to the detriment of more sustainably focused funds.

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But where ESG funds should demonstrate their potential more significantly is once the first phase of the economic recovery is complete. As many have noted, in the medium term, there is an opportunity to 'build back better' – establishing a cleaner and greener economy that is ultimately more sustainable.

This could entail a shift towards a 'circular economy', in which resources are not wasted and recycling is prioritised. Already, some governments are taking significant steps in this direction – as in the European Union, where there is agreement that the economic recovery should be consistent with the 'green transition', and in South Korea, where the government has announced a 'green deal' to stimulate the economy and target zero net emissions by 2050. Such outcomes cannot be taken for granted, however. In the US, for example, the government is favouring fossil-fuel companies over producers of clean energy in its stimulus efforts.

Any moves towards a greener economy should reward the environmental focus of ESG funds. But the social and governance aspects of ESG may also receive renewed attention during the recovery from the pandemic. This crisis has highlighted extensive social inequalities, with many marginalised communities suffering to a greater degree. There is little doubt that the pandemic will change the way our societies operate. Companies that address these social inequalities and adopt responsible business practices will be better placed to adapt to the new world that emerges in its wake. For example, those that offer flexible and remote working as standard will be able to adapt more quickly to a situation that requires social distancing to be maintained for a considerable time. And those that work to ensure their employees' wellbeing should have a more health, resilient and stable workforce.

And most fundamentally, governance – the G in ESG – will be crucial to companies' chances of coming through the crisis in good shape. There is a considerable opportunity for the most responsibly run companies to emerge from the crisis with improved operations and enhanced reputations. By identifying these companies, the managers of ESG strategies can offer investors the prospect of investing in a better and more sustainable future.

Ultimately, the short-term outperformance of ESG funds may simply underscore the durable and sustainable characteristics of the companies in which they invest. Those are the qualities that will serve those companies and their investors well in the future – and advance the interests of all of us at the same time.

*Assumptions are built on stocks that are in the top quintile (top 20%) based on Sustainalytics' ESG rating have outperformed the S&P 500 since Q4 2018

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