Aegon Asset Management

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WHY ESG MATTERS IN A CRISIS

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Key Takeaways

- During market turmoil, ESG criteria can help identify risk factors and evaluate corporate resilience, stranded asset risk and management quality.
- Investing in companies with stronger ESG practices or alignment with sustainable themes can lead to more resilient portfolios during a downturn.
- ESG and responsible investing momentum is likely to continue as companies strive to serve various stakeholders and investors seek to effect measurable positive change.

What has been the role of ESG during the Covid-19 crisis?

Challenging markets can provide an opportunity for ESG to demonstrate its value. After a historic bull market, the recent market fallout provided an opportunity to test the resilience of ESG and responsible investment solutions. Although the time period has been short and few areas were left unscathed, certain ESG-focused or responsible investment strategies have weathered the storm and, in many cases, outperformed traditional products. For example, studies from Morningstar[1] and MSCI[2] have shown that the majority of ESG indices held up better than their parent indices during the first quarter. Further, many focused responsible investment solutions, such as best-in-class ESG or sustainability-themed strategies, have demonstrated greater resilience than their traditional counterparts. The results are not surprising, and they reinforce our responsible investment philosophy and view that ESG factors can help manage risk and potentially generate long-term value.

How can ESG factors help manage risk holistically throughout a portfolio?

In a downturn, whether it's caused by Covid-19 or anything else, you will generally find that the companies that are better at managing their business' risk will outperform their peers. The crisis highlights the ability of ESG factors to help us better understand corporate resilience to shocks. After all, risk management is at the heart of ESG integration practices. Material ESG topics have an impact on the bottom line and on the financial performance of corporate issuers.

ESG is often a very good proxy for quality of management, which is critically important in a crisis. As we've seen over the last few months, businesses with high-quality leadership tend to place a greater importance on their role in society and are more likely to prioritize workplace safety and employee well-being.

At the same time Covid-19 is giving us a glimpse of what markets look like when stranded assets are recognized. We experienced a demonstration when oil was literally stranded, albeit briefly, with insufficient storage capacity, driving futures into negative territory. Was that a market blip due to unforeseen demand collapse and a glut caused by geopolitical issues? Sure, but it also highlighted the financial materiality of ESG issues, and makes you wonder if many more such shocks might be in store. Are we spending enough time on analyzing and quantifying this risk?

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In short, a company's ability to navigate environmental and societal disruptions, combined with governance practices, can have a profound effect on its ability to mitigate downside risk and create long-term value.

How can ESG also help uncover opportunities and potentially create long-term value?

A focus on companies with stronger ESG practices or a focus on sustainable products and services can present opportunities to generate upside potential. For example, companies focused on solving pressing sustainability issues through the products and services they sell may benefit by retaining or attracting customers, driving revenue growth, and generating lower operating costs. As a result, these companies may be more likely to produce sustainable cash flows and more resilient business models over the long term. This may sound straightforward in theory, but in practice, ESG integration and responsible investing requires a robust, multi-faceted investment framework to uncover these opportunities.

[1] https://www.morningstar.com/insights/2020/04/06/how-did-esg-indexes-fare
[2] https://www.msci.com/www/blog-posts/msci-esg-indexes-during-the/01781235361

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How have responsible investment strategies held up during the Covid-19 crisis?

Broadly speaking, we've observed that companies with stronger ESG practices have generally demonstrated greater resilience during the recent downturn. For example, within our High Yield ESG strategy, we've found that positive ESG screening used in a best-in-class approach can help lessen the exposure to downside risk and potentially generate outperformance versus the benchmark.

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We're also finding that a sustainability-themed approach to fixed income may be beneficial during a downturn. While we'd be remiss to make blanket statements at this point, certain companies and sectors are positioned to emerge as winners and losers. Many companies with a greater focus on sustainability, such as technology and healthcare, have weathered the short-term downturn relatively well. By contrast, industries with weaker sustainability profiles, such as energy and leisure, which are important pieces of the global economy, have suffered greatly. This is to be expected – when the chips are down, consumers are likely to focus on what really matters. While many unknowns remain, we remain convinced that sustainability is a secular trend that will extend well beyond the crisis.

Finally, the current crisis presents an excellent opportunity to crystalize our view of good ESG management. Some companies previously thought to be leading in terms of policies and management systems may well demonstrate rather poor ESG performance – and vice versa. We are closely monitoring how companies – especially those seeking bailouts – are managing employee health and safety, as well as governance actions.

What are the essential elements of an ESG integration framework?

We believe it's critical to develop a holistic ESG opinion that is integrated with your financial analysis and aligned with your firm's in-house view of the world. Many ESG issues are open to interpretation, and this is reflected in the lack of correlation between the various third-party ESG scores and ratings. Rather than look at the lack of correlation in third-party ESG data as a hindrance, we see it as an opportunity for active managers like us to demonstrate the value of a proprietary ESG approach. By looking at multiple ESG data sources, we are able to identify inherent biases, weigh different approaches and synthesize a more holistic view of the issuer's ESG profile.

What does asset management look like in a post-pandemic world? Do you think we are at a tipping point for ESG?

We firmly believe that the asset management industry will emerge from the crisis with a greater sense of responsibility. As stewards of clients' capital, we focus on managing capital responsibly in an effort to pursue competitive long-term returns in a world where the air is still breathable, the water is drinkable, and the streets are safe. Covid-19 highlights this fundamental responsibility.

When we look back on this year, it may be viewed as an unprecedented period when ESG was put to the test and demonstrated its potential value. In that sense, we believe we may have already moved beyond the ESG tipping point. ESG integration is generally becoming the norm and investors are increasingly placing greater importance on responsible investing. Crises often accelerate or accentuate existing trends – from that perspective, ESG is positioned to become an avalanche.

Looking ahead, we expect companies will place a greater importance on serving the needs of various stakeholders

Looking ahead, we expect companies will place a greater importance on serving the needs of various stakeholders – customers, employees, shareholders, suppliers, and local communities – as they strive to go beyond delivering financial returns to shareholders. Within asset management, the conversation may shift from "returns" to "impact" as investors increasingly aspire to use their capital to effect measurable positive change.

Related literature

Evaluating Sustainable Winners & Loser of the Covid-19 Crisis
Aegon Asset Management Responsible Investment Report 2019

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